

# INTERNATIONAL FINANCE - SPRING 2011

## CHAPTER 1: INTRODUCTION

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### 1.0 INTRODUCTION TO THE TRANSNATIONAL FINANCIAL SYSTEM

Transnational financial activity includes many different types of activity. Firms buy and sell currencies; people buy debt or equity securities issued by companies established in foreign jurisdictions, banks lend money to foreign borrowers; foreign firms enter the US markets and sell their securities to US persons or lend money to US borrowers; insurance companies pass on the risks associated with policies they have written to reinsurers based in other jurisdictions; people and businesses use different mechanisms to send money around the world.

International financial activity therefore involves the payment system, whereby funds are transmitted around the world, and a number of different financial markets: foreign exchange markets, securities markets, debt markets and markets for derivative financial

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instruments.<sup>2</sup> In all of these markets regulators worry about ensuring that the architecture of the systems and markets is sound, and that market participants behave properly. Regulators also worry about whether the payments system and the financial markets are being used to launder money derived from illicit sources.

The regulation of financial market activities which take place in different jurisdictions is a matter for the domestic regulators in the jurisdictions involved. In a federal system such as that in the US, financial regulation may be carried out by the states or at the federal level, or both. Domestically there are issues about the allocation of regulatory responsibilities within federal regimes. In addition, different national regulators may have an interest in the regulation of financial market activity which crosses borders. If a bank based in one country wants to do business in another country the banking regulators in both countries may have an interest in regulating the bank's activities. But the imposition of two sets of different rules on a financial institution which engages in cross-border business increases the cost to the bank of doing business, so regulators based in different jurisdictions may agree to harmonize the rules which apply to financial institutions engaged in cross-border business. The International Organisation of Securities Commissions (IOSCO), the Basle Committee on Banking Supervision (Basle Committee), and the International Association of Insurance Supervisors (IAIS) are supranational bodies which work on developing harmonized principles of financial regulation. The European Union is creating a single market in financial services, which is analogous to a system for allocating regulatory responses within a federal system.

Although transnational financial activity involves issues for regulators, it is accomplished through contracts, and involves issues of interpretation and validity of contracts, and issues of choice of law and jurisdiction. Financial contracts may be short term contracts, such as a sale of securities, but they may also be medium or longer term contracts, establishing ongoing relationships between the parties. And where a party to a financial transaction becomes insolvent, courts in different jurisdictions may be interested in the resolution of matters to do with the insolvency. As well as thinking about harmonization of regulatory law we will also be thinking about conflicts of laws issues and issues relating to harmonization of private law.

Recent events in the markets have raised new questions for the regulation of transnational financial transactions. The IMF, which has been subject to some challenges

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<sup>2</sup> Derivatives are instruments whose value derives from the value of an underlying asset (for example a loan or a commodity such as coffee), index (for example interest rates or exchange rates) or phenomenon (such as weather conditions). Futures, options and swaps are derivatives.

over the last few years,<sup>3</sup> now sees a new role for itself.<sup>4</sup> Olivier Blanchard, Economic Counsellor and Director of the Research Department at the IMF, has written:

The crisis has made clear that the financial system is a global system, with strong interconnections across countries. What was initially a U.S. crisis is now affecting the entire world. National policymakers cannot do the job alone: what happens to them depends not only on their own regulatory structure, but also on the regulatory structure of other countries; not only on systemic risk at the national level, but also on the buildup of systemic risk elsewhere. Monitoring systemic risk at the global level is essential. The IMF seems best equipped to do the job, in collaboration with central banks and other international organizations. This will imply expanding our global surveillance role, and this is something on which we have to start working right now.<sup>5</sup>

Until very recently it was taken for granted that participants in international or transnational financial transactions were very wealthy individuals, large corporates and financial firms. But the remittance market illustrates that even people who are not very wealthy may engage on a regular basis in transnational financial transactions.<sup>6</sup> International financial institutions and domestic banking regulators and politicians have focused on the remittance market in which migrant workers rely on remittance services, which may be informal services or part of the formal financial system, to send money home to their families. The remittance market was affected by the economic downturn: during 2009, remittances

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<sup>3</sup> The IMF has been criticized over the years, for example, critiques of conditionality and the Washington consensus, and of the IMF's non-representative governance arrangements. The IMF has responded to the critiques by introducing governance reforms. See, e.g., IMF, IMF Board of Governors Approves Major Quota and Governance Reforms (Dec. 16, 2010) at <http://www.imf.org/external/np/sec/pr/2010/pr10477.htm> .

<sup>4</sup> The IMF for some years has had a program for monitoring compliance by IMF member countries with harmonized principles of governance and regulation, called Reports on the Observance of Standards and Codes (ROSCs). See <http://www.imf.org/external/np/rosc/rosc.asp>. See also, Lex Riefel, Building a Better Global Financial System, (Nov. 12, 2008) available at [http://www.brookings.edu/opinions/2008/1112\\_global\\_finance\\_rieffel.aspx](http://www.brookings.edu/opinions/2008/1112_global_finance_rieffel.aspx).

<sup>5</sup> Olivier Blanchard, Cracks in the System: Repairing the Damaged Global Economy, Finance and Development, 9 (Dec. 2008) available at <http://www.imf.org/external/pubs/ft/fandd/2008/12/pdf/blanchard.pdf> .

<sup>6</sup> On remittances see, e.g., the Inter-American Development Bank's resources at <http://www.iadb.org/mif/subtopic.cfm?language=English&SUBTOPIC=REMS&TOPIC=> ; World Bank, Migration and Remittances Factbook 2011 at <http://data.worldbank.org/data-catalog/migration-and-remittances-2011>.

from the US to Mexico decreased.<sup>7</sup> On the other hand, remittances to Bangladesh, Pakistan and the Philippines grew.<sup>8</sup> During 2010 remittance levels increased again.<sup>9</sup> Although the amounts involved in individual remittance transactions may be small, the market as a whole is significant. Remittances to developing countries reached \$338 billion in 2008.<sup>10</sup>

Remittance systems raise issues for regulators concerned about money laundering. For example the Financial Action Task Force has identified alternative (i.e. informal or unregulated) remittance systems as possible vehicles for money laundering.<sup>11</sup> A concern to prevent money laundering would therefore tend to make policy-makers prohibit remittances through unregulated channels, even if such channels were cheaper for customers than regulated channels. The remittance example illustrates that there may be a number of policy issues implicated by a particular financial market or type of transaction.

The costs of making overseas remittances through formal channels have generally decreased over the last few years, although some consumers still complain about crippling fees by some money transmitters.<sup>12</sup> In 2005, the UK's Department for International Development sponsored a website to help people remit money more cheaply.<sup>13</sup> Price

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<sup>7</sup> See, e.g., Ronald Buchanan, US-based Mexicans send less money home, Financial Times (Jan. 5, 2010).

<sup>8</sup> See, e.g., Migration and Remittances Team, Development Prospects Group, World Bank, Migration and Development Brief 11 (Nov. 3, 2009) at <http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1110315015165/MigrationAndDevelopmentBrief11.pdf>

<sup>9</sup> See, e.g., Migration and Remittances Team, Development Prospects Group, World Bank, Migration and Development Brief 13 (Dec. 2010) at <http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1110315015165/MigrationAndDevelopmentBrief13.pdf>. (“Recorded remittance flows to developing countries are estimated to have fully recovered to the pre-crisis level of \$325 billion in 2010. In line with the World Bank's outlook for the global economy, remittance flows to developing countries are expected to increase by 6.2 percent in 2011 and 8.1 percent in 2012, to reach \$346 billion in 2011 and \$374 billion in 2012 respectively.”)

<sup>10</sup> Migration and Development Brief 11, note [8](#) above.

<sup>11</sup> Financial Action Task Force, Money Laundering and Terrorist Financing Typologies 2004-5 pages 3-40 (Jun. 2005) available at <http://www.fatf-gafi.org/dataoecd/16/8/35003256.pdf>.

<sup>12</sup> See, e.g., Western Union: Stop the crippling fees! at [http://www.avaaz.org/en/make\\_giving\\_powerful?fp](http://www.avaaz.org/en/make_giving_powerful?fp).

<sup>13</sup> The website was originally called <http://www.sendmoneyhome.org/>. See also UK Remittance Working Group, UK Remittance Market, 30 (Nov. 2005) at <http://www.eldis.org/vfile/upload/1/document/0708/DOC22284.pdf>. Subsequently the website changed its

comparison websites encourage competition, and technology also facilitates cheaper payments, so that the World Bank's Migration and Remittances Team now states:

Increasing competition and structural and regulatory changes have gradually put downward pressure on remittance costs. According to the World Bank Remittance Prices Worldwide database, the average remittance cost for sending \$200 fell from 9.8 percent in the last quarter of 2008 to 8.7 percent in the first quarter of 2010 (figure 16). Remittance cost in the US-Mexico remittance corridor fell between 1999 and 2005, from nearly 10 percent of the transaction amount in 1999 to less than 5 percent in 2005 because of greater competition (World Bank 2006). However, average costs in other corridors – particularly in Sub-Saharan Africa and the Pacific Islands, and in almost all South-South remittance corridors – have continued to remain high.<sup>14</sup>

The US House Committee on Financial Services held hearings in 2003 on the issue of whether remittance services should be regulated,<sup>15</sup> and, the Dodd-Frank Act of 2010 has implications for remittances:

The Wall Street Reform and Consumer Protection Act signed into law by President Obama on July 21, 2010 also aims to increase transparency in the pricing of remittance services. Providers of remittance services (RSPs) in the United States will be required to disclose to remitters the equivalent amount that will be received in local currency by the beneficiary, the fees for the transaction, access to error-resolution mechanisms, and contact details of the relevant regulatory authority. Remittance issues are going to be integrated into the strategy for financial literacy for low-income communities, as part of the US government's Strategy for Assuring Financial Empowerment (SAFE). Finally, the Federal Reserve and Treasury will work to extend automatic clearing house (ACH) systems and other payment systems for remittances to foreign countries, with a focus on countries that receive significant remittance transfers from the United States. Studies will be conducted on the feasibility of using remittance history to improve credit scores and the legal and business model barriers to such credit scoring.

However, the United States subsequently announced plans to implement regulations that will severely

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name to <http://www.fxcompared.com/> and became a "fully-fledged commercial money transfer price comparison site".

<sup>14</sup> Migration and Development Brief 13, note [9](#) above, at 10.

<sup>15</sup> See, e.g., Testimony of Wayne A. Abernathy, Assistant Secretary of the Treasury for Financial Institutions, before the US House Committee on Financial Services, Oct. 1, 2003, *available at* <http://financialservices.house.gov/media/pdf/100103wa.pdf> (suggesting that Treasury thinks that promoting competition in remittance services is the answer).

reduce or eliminate threshold requirements for reporting cross-border money transfers. Under the proposed requirements, banks will have to report all cross-border money transfers, and money transfer operators will have to report only transactions greater than \$1,000. There is lack of clarity about whether these thresholds are consistent with those recommended by the inter-governmental Financial Action Task Force (FATF) for customer due diligence (CDD). The FATF thresholds are themselves subject to interpretation. In practice, many countries require remittance service providers to undertake CDD for transaction below 1,000 US dollars or euros. In some cases, the CDD requirement applies to all remittance transactions. This could be for example if regulators believe that remittance transfers are highly vulnerable to money laundering or terrorist financing. While the majority of migrant remittance transactions are below \$1,000, a lack of clarity on these regulations has increased the cost of compliance for community banks and smaller money transfer operators. Concurrently, the European Payments Services Directive (PSD) implemented in the European Union will have implications for transparency and improved consumer protection for remittance services. For example, a new type of institution called a Payment Institution (PI) has been created that is subject to less stringent licensing, capital, and reporting requirement compared to conventional banks and financial institutions (Previously money transfer operators had to register as financial institutions in some EU countries). In addition, in the UK remittance transactions will come under the independent Financial Ombudsman service for the first time... Although the PSD applies only for transactions from one EU country to another, some remittance-sending countries such as Italy have extended these rules for transfer to third-countries outside the EU.<sup>16</sup>

Regulation in countries from which payments are sent and into which payments are sent may affect the costs of sending money. For example, if a country prohibits credit unions but not banks from receiving remittances, credit unions in that country may be forced to become banks.<sup>17</sup> Remittances may have an impact on the conditions in the domestic financial markets in the countries where the recipients of remittances live. Remittance recipients may be more attractive to local banks as borrowers because of their receipts of funds and this may encourage the development of credit markets. On the other hand remittance recipients may need less credit if they are receiving funds from remittances. Cross-border transactions may affect local conditions in one domestic financial system: domestic financial markets are increasingly related to each other. Some have argued that countries should issue Diaspora bonds as a way of raising funds from wealthy expatriates.<sup>18</sup>

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<sup>16</sup> Migration and Development Brief 13, note [9](#) above, at 10-11.

<sup>17</sup> See, e.g., Abernathy, note [15](#) above.

<sup>18</sup> See, e.g., Migration and Development Brief 13, note [9](#) above, at 12-13.

Remittances illustrate a distinction between formal and informal financial activity.<sup>19</sup> Remittances may be sent through formal channels such as wire transfers through regulated financial institutions, or they may be sent through informal transfer mechanisms. Concerns about money laundering and terrorist financing in particular, tend to push financial activity into formal regulated channels, requiring money transmitters to be regulated. Regulation involves compliance costs which tend to be borne by consumers of regulated services. Increasing the costs of providing remittance services in order to control money laundering by organised criminals harms the interests of non-criminal remitters of money.

### **Financial Action Task Force (FATF), Special Recommendations on Terrorist Financing (Oct. 22, 2004)**

#### I. Ratification and implementation of UN instruments

Each country should take immediate steps to ratify and to implement fully the 1999 United Nations International Convention for the Suppression of the Financing of Terrorism.

Countries should also immediately implement the United Nations resolutions relating to the prevention and suppression of the financing of terrorist acts, particularly United Nations Security Council Resolution 1373.

#### II. Criminalising the financing of terrorism and associated money laundering

Each country should criminalise the financing of terrorism, terrorist acts and terrorist organisations. Countries should ensure that such offences are designated as money laundering predicate offences.

#### III. Freezing and confiscating terrorist assets

Each country should implement measures to freeze without delay funds or other assets of terrorists, those who finance terrorism and terrorist organisations in accordance with the United Nations resolutions relating to the prevention and suppression of the financing of terrorist acts.

Each country should also adopt and implement measures, including legislative ones, which would enable the competent authorities to seize and confiscate property that is the proceeds of, or used in, or intended or allocated for use in, the financing of terrorism, terrorist acts or terrorist organisations.

#### IV. Reporting suspicious transactions related to terrorism

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<sup>19</sup> For example: "Mobile money transfers have the potential to revolutionize access to remittance services and broader financial services for the poor. There is a compelling reason for applying mobile technology to cross-border remittance services: the bulk of poor cross-border migrants tend to travel short distances, mostly to neighboring countries just across the border,..and a large number of them stay within the calling range of domestic mobile phones. Such migrants typically cannot have bank accounts in the host country, and in any case banks do not want to serve them. These migrants rely on friends (or strangers) going home or hawaladars to send money home." Migration and Development Brief 13, note [9](#) above, at 11.

If financial institutions, or other businesses or entities subject to anti-money laundering obligations, suspect or have reasonable grounds to suspect that funds are linked or related to, or are to be used for terrorism, terrorist acts or by terrorist organisations, they should be required to report promptly their suspicions to the competent authorities.

#### V. International co-operation

Each country should afford another country, on the basis of a treaty, arrangement or other mechanism for mutual legal assistance or information exchange, the greatest possible measure of assistance in connection with criminal, civil enforcement, and administrative investigations, inquiries and proceedings relating to the financing of terrorism, terrorist acts and terrorist organisations. Countries should also take all possible measures to ensure that they do not provide safe havens for individuals charged with the financing of terrorism, terrorist acts or terrorist organisations, and should have procedures in place to extradite, where possible, such individuals.

#### VI. Alternative remittance

Each country should take measures to ensure that persons or legal entities, including agents, that provide a service for the transmission of money or value, including transmission through an informal money or value transfer system or network, should be licensed or registered and subject to all the FATF Recommendations that apply to banks and non-bank financial institutions. Each country should ensure that persons or legal entities that carry out this service illegally are subject to administrative, civil or criminal sanctions.

#### VII. Wire transfers

Countries should take measures to require financial institutions, including money remitters, to include accurate and meaningful originator information (name, address and account number) on funds transfers and related messages that are sent, and the information should remain with the transfer or related message through the payment chain.

Countries should take measures to ensure that financial institutions, including money remitters, conduct enhanced scrutiny of and monitor for suspicious activity funds transfers which do not contain complete originator information (name, address and account number).

#### VIII. Non-profit organisations

Countries should review the adequacy of laws and regulations that relate to entities that can be abused for the financing of terrorism. Non-profit organisations are particularly vulnerable, and countries should ensure that they cannot be misused:

1. by terrorist organisations posing as legitimate entities;
2. to exploit legitimate entities as conduits for terrorist financing, including for the purpose of escaping asset freezing measures; and
3. to conceal or obscure the clandestine diversion of funds intended for legitimate purposes to terrorist organisations.”



IX.<sup>20</sup> Cash Couriers

Countries should have measures in place to detect the physical cross-border transportation of currency and bearer negotiable instruments, including a declaration system or other disclosure obligation.

Countries should ensure that their competent authorities have the legal authority to stop or restrain currency or bearer negotiable instruments that are suspected to be related to terrorist financing or money laundering, or that are falsely declared or disclosed.

Countries should ensure that effective, proportionate and dissuasive sanctions are available to deal with persons who make false declaration(s) or disclosure(s). In cases where the currency or bearer negotiable instruments are related to terrorist financing or money laundering, countries should also adopt measures, including legislative ones consistent with Recommendation 3 and Special Recommendation III, which would enable the confiscation of such currency or instruments.

“Money service businesses” are subject to money laundering regulation in many jurisdictions, as well as banks and other types of financial firm.<sup>21</sup> This idea that services “for the transmission of money or value” should be regulated catches informal value transmission systems. Should phone companies which allow payments via mobile phones be subject to regulation as money transmitters?<sup>22</sup> The FATF has focused its attention on New Payment Methods (NPMs) which include mobile phone payments, internet payments and prepaid cards:

NPMs: risk vs. opportunity

55. On the one hand NPMs, like all financial services and products, can be abused for ML/TF<sup>23</sup> purposes. Most jurisdictions have therefore subjected NPM service providers to AML/CFT<sup>24</sup>

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<sup>20</sup> This provision was added to the 2001 version in 2004. The FATF website is at <http://www.fatf-gafi.org>.

<sup>21</sup> See, generally, e.g., [http://www.fincen.gov/financial\\_institutions/msb/](http://www.fincen.gov/financial_institutions/msb/).

<sup>22</sup> Migration and Development Brief 13, note 9 above, at 12 (“There are some small pilots for cross-border remittances (e.g. from the UK and US to Safaricom’s M-Pesa mobile money accounts in Kenya), but by and large the mobile phone remittances have stayed within national borders. Conversations with market players suggest that a lack of clarity on anti-money-laundering and combating the financing of terror (AML-CFT) regulations remains a major barrier to the entry of cross-border remittance service providers.”)

<sup>23</sup> ML/TF refers to Money Laundering/Terrorist Financing.

<sup>24</sup> AML/CFT refers to Anti Money Laundering/Combating the Financing of Terrorism.

obligations and regulation.

56. On the other hand, where NPM providers are subject to AML/CTF obligations and appropriately supervised for AML/CTF purposes, NPMs can make payment transactions more transparent and help prevent corruption or other abuses. NPMs can shift customers from the unsupervised or even illegal sections of the payments market (e.g., hawaladars, underground banking services) into the formal sector. This means that where providers are subject to AML/CTF legislation and supervision, more transactions are monitored and suspicious transactions are identified and reported to a competent authority. Ultimately, this should result in better oversight of payment activities within a jurisdiction.. Contrary to cash, NPMs can provide additional investigative leads for law enforcement agencies. This is because a transaction carried out through a NPM will always generate an electronic record, whereas cash does not. Even where CDD<sup>25</sup> measures are not applied (i.e., where the customer remains anonymous), the electronic record can, in some cases, still provide law enforcement with at least minimal data such as an IP address or the place where a payment was executed or funds withdrawn; this can potentially support the location or identification of a user suspected of money laundering or terrorist financing...

The verification of the customers' identity may be further hampered or impossible in jurisdictions that have no national identity card scheme, or other appropriate alternative forms of identification; this is a challenge often encountered by NPM providers operating in underbanked regions, especially mobile payment services providers. For this reason, the World Bank has recommended to jurisdictions intending to promote financial inclusion (e.g., through mobile payment service providers) that if the jurisdiction's "national identification infrastructure and other private databases lack coverage, integrity, or are not easily and cost-effectively accessible to financial institutions for verification purposes, the state should address these deficiencies". Where customer data cannot be reliably verified, it may be appropriate to apply alternative risk mitigation measures (e.g., imposing low value limits in order to qualify as a "low risk" product and be allowed to apply simplified CDD measures..).. Providers of products with high or no value limits are often based in jurisdictions where NPM providers are not or insufficiently regulated and supervised for AML/CTF purposes, but sell their product internationally (through agents or over the Internet). However, such providers of anonymous prepaid cards with high or no limits have also been found to operate in jurisdictions whose regulatory regimes and supervision are generally considered robust. Such anonymous cards are often not promoted by the issuing institution itself, but by intermediaries some of which have specialised in founding and selling companies abroad, preferably in tax havens, thus providing a complete "privacy package" to their customers. Some of those anonymous prepaid cards however have been discovered to be fraudulent. <sup>26</sup>

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<sup>25</sup> CDD refers to Customer Due Diligence (or Know Your Customer).

<sup>26</sup> Excerpt from FATF, Money Laundering Using New Payment Methods (Oct. 2010) at <http://www.fatf-gafi.org/dataoecd/4/56/46705859.pdf> (footnotes omitted and footnotes added).

## 2.0 FINANCIAL REGULATION, TRUST, AND CONFIDENCE IN THE FINANCIAL MARKETS

Countries regulate domestic financial activity to protect investors, depositors, and other categories of consumer in order to preserve the domestic financial markets. The essential functions of financial markets are relatively simple: they enable businesses to raise money, and investors to obtain a return on capital they do not need for current consumption. Both of these functions are crucial to the functioning of capitalist economies. Businesses need to ensure supplies of capital in order to grow, and investors need to be able to provide for their future needs. The functions are also linked, as, ultimately, the money that businesses use comes from investors. If investors do not feel safe in committing their money to the businesses which need the money, they will refuse to invest, perhaps hiding the money under their mattresses. Moreover, if financial firms fail their failures may be transmitted to other financial firms through the payments system.<sup>27</sup> Such failures harm confidence. Thus, governments are convinced of the need to act to maintain investor/depositor confidence in the financial markets. Over the period since the summer of 2007 we have seen what happens when market participants lose confidence in the financial markets. In this period of turmoil, some of the regulatory mechanisms which had been designed to maintain confidence turned out to be ineffective.<sup>28</sup>

Consider **William J. McDonough's** comments from September 2002:

Governments have long recognized that banking and other financial institutions, because of the

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<sup>27</sup> In 2003, Anne Krueger said that "At the domestic level, governments must take steps to ensure a sound banking system. That means addressing issues such as non-performing loans, capital adequacy ratios and effective regulation. It means ensuring there is proper competition within the banking sector. And it means ensuring that there are incentives in place so that financial institutions develop the appropriate skills needed to assess and manage credit risks and returns." Anne Krueger, First Deputy Managing Director of the International Monetary Fund, *Financing the Future: Why a Thriving Capital Market Matters*, Speech at the National Economic Outlook Conference, Kuala Lumpur, Malaysia, Dec. 9, 2003, available at <http://www.imf.org/external/np/speeches/2003/120903.htm>. Anne Krueger was the World Bank Chief Economist from 1982 to 1986, and the first Deputy Managing Director of the International Monetary Fund from September 1, 2001, to September 1, 2007. She is now a Professor at Johns Hopkins' School of Advanced International Studies.

<sup>28</sup> Deposit insurance schemes are an example of this. Deposit insurance schemes are supposed to prevent bank runs by persuading depositors that their money is safe. But depositors' fears that they might have to wait for their money prompted legislators to rethink deposit insurance schemes. See Sebastian Schich, *Financial Turbulence: Some Lessons Regarding Deposit Insurance*, *Financial Market Trends* No. 94, 55 (Volume 2008/1) available at <http://www.oecd.org/dataoecd/32/54/41420525.pdf>

nature of the functions they perform, must be subject to at least some form of regulation and official oversight. Governments have a broad mandate here. Their job is to ensure that markets operate in a fair, transparent, and efficient manner, and that participants comply with the rules of the game. Governments must not rely on outdated notions as to what constitutes risk and effective risk management. Official supervision must evolve in line with the way financial institutions manage their activities, which is increasingly across business lines rather than across legal entities.<sup>29</sup>

**Think about what this statement suggests about the appropriate role of regulators. The reference to “at least some form of regulation and official oversight” (emphasis added) seems to suggest a limited role for regulators. Do you think this is what McDonough really means? Is it realistic to think that markets can “operate in a fair, transparent, and efficient manner”? Who should decide what “effective risk management” requires - governments, financial firms, or investors/ depositors? Do these questions become more or less complex when we think of how domestic financial markets are linked to other domestic financial markets? If you were a US banking regulator would you trust(a) US banks and/or (b) foreign banks to decide on their own risk management principles? Would you trust financial trade associations (groups of banks) to develop such principles? Would it make a difference which foreign countries the banks were based in?**

**Are your views on these questions different in early 2011 from those you would have held before the financial crisis?**

**Note that these comments relate to institutional regulation - the regulation of firms involved in the financial markets. Other types of rule regulate specific transactions - for example disclosure rules and rules requiring approval of certain financial products by regulators.**

At the end of 2001 Enron restated its financials for the prior four years, so that earnings from 1997 to 2000 declined by \$591 million, and debt for 2000 increased by \$658

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<sup>29</sup> William J. McDonough, (then) President and Chief Executive Officer, Federal Reserve Bank of New York, *Issues in Corporate Governance*, The William Taylor Memorial Lecture, Washington, D.C. (Sep. 29, 2002) available at <http://www.ny.frb.org/newsevents/speeches/2002/mcd020929.html> . (McDonough was at one point the chair of the Basle Committee on Banking Supervision, and he was Chairman of the Public Company Accounting Oversight Board from 2003-2005 (PCAOB). The PCAOB is the body set up under the Sarbanes-Oxley Act of 2002 to deal with post-Enron issues).

million. Enron subsequently went into bankruptcy.<sup>30</sup> The Enron mess and other corporate collapses and scandals involving companies including Tyco, Worldcom and Parmalat prompted regulators and legislators to act to protect investor confidence. The scandals and collapses raised a number of different questions about the regulation of financial markets involving:

- the constraints on US corporate officers and directors
- ensuring that financial disclosures accurately reflect the financial condition of issuers of securities (e.g. accounting for securitization, principles-based versus rules-based accounting regulation, regulating auditors, certification of company accounts)
- how to make sure that financial analysts do not mislead investors as to the value of securities
- the role of credit rating agencies.<sup>31</sup>

**McDonough** said in 2002:

This past year brought widespread questioning of the quality and integrity of the information available to the market and the behavior of some corporate executives. Although the developments that gave rise to this questioning are regrettable, there has, in fact, been a positive side. The public uproar that these developments have created and the turmoil they have generated in the financial markets have been immensely powerful as forces for meaningful reform. I further believe that the painful experiences of this year will help educate a generation of younger managers about the importance of integrity and sound corporate governance based on independent oversight and strong internal checks and balances.<sup>32</sup>

In 2004 **Alan Greenspan** also discussed the importance of trust in financial markets:

Recent transgressions in financial markets have underscored the fact that one can hardly overstate the importance of reputation in a market economy. To be sure, a market economy requires a

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<sup>30</sup> Paul M. Healy, Krishna G. Palepu, *The Fall of Enron*, 17(2) J. OF ECON.PERSPECTIVES, 3, 4 (2003).

<sup>31</sup> Credit rating agencies such as Standard & Poors and Moodys are businesses which assign ratings to firms and to the securities they issue which reflect the risks that the firms will default (the credit risk). But credit rating agencies are paid by the firms they rate, which suggests to many observers that they are subject to severe conflicts of interest. Such concerns have led policy makers to focus on improving the regulation of credit rating agencies.

<sup>32</sup> McDonough speech, note [29](#) above.

structure of formal rules—for example, a law of contracts, bankruptcy statutes, a code of shareholder rights. But rules cannot substitute for character. In virtually all transactions, whether with customers or with colleagues, we rely on the word of those with whom we do business. If we could not do so, goods and services could not be exchanged efficiently. The trillions of dollars of assets that are priced and traded daily in our financial markets before legal confirmation illustrate the critical role of trust. Even when followed to the letter, rules guide only a few of the day-to-day decisions required of business and financial managers. The rest are governed by whatever personal code of values that managers bring to the table....

Over the past half century, the American public has embraced the protections of the myriad federal agencies that have largely substituted government financial guarantees and implied certifications of integrity for business reputation. As a consequence, the market value of trust so prominent in the nineteenth century seemed unnecessary and by the 1990s appeared to have faded to a fraction of its earlier level.

Presumably, we are better protected and, accordingly, better off as a consequence of these governmental protections. But corporate scandals of recent years have clearly shown that the plethora of laws of the past century have not eliminated the less-savory side of human behavior. We should not be surprised then to see a re-emergence of the market value placed on trust and personal reputation in business practice. After the revelations of corporate malfeasance, the market punished the stock prices of those corporations whose behaviors had cast doubt on the reliability of their reputations. Recent allegations on Wall Street of breaches of trust or even legality, if true, could begin to undermine the very basis on which the world's greatest financial markets thrive.<sup>33</sup>

In 2002 market participants also joined in talking about investor confidence:

Our industry, too, deserves a portion of the blame for the market's performance. The collapse of Enron, and then WorldComm, led to concerns about the independence and integrity of the analysts who evaluate whether companies are good investments. We have also faced questions about the underwriting process, and whether allocations of initial public offerings were used to attract business for firms.

All of these developments - the sharp drop in the market's performance, the revelations of corporate fraud, and the doubts about Wall Street's role in the crisis - have led many investors to question the wisdom of putting their hard-earned savings into stocks and bonds.

The survey we are releasing today shows that investors' attitudes toward the securities industry and their brokers are at their lowest levels since we began our survey in 1995. Investors told us they are most concerned about losing money in their stock investments and about dishonesty within the marketplace. They told us that we, the industry, should be more honest and trustworthy and be more

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<sup>33</sup> <http://www.federalreserve.gov/boarddocs/speeches/2004/20040416/default.htm>

willing to punish the wrongdoers.

Against this backdrop, we have convened our annual meeting around the theme of "building confidence." That's where our focus must be right now. It's vitally important that we address investor concerns and restore trust in the financial markets.

But we must not lose sight of the fact that we are "building confidence" on a firm foundation of experience, skill, and knowledge. The SIA has drawn deeply on these qualities over the past year as we have set ourselves to the task of restoring and sustaining investor trust.<sup>34</sup>

Although many of the events which created doubts about corporate governance and financial regulation in recent years occurred in the US, regulators in other jurisdictions were also concerned about investor confidence. But as many in the US were focusing on the costs of new rules, market participants and policy makers in other parts of the world also focused on the costs of regulation. In 2005 the EU's then Internal Market Commissioner, **Charlie McCreevy**, said that he wanted to make sure that businesses were not subjected to excessive regulation:

I want to make life easier for our companies. When I finish at the Commission, there is just one question I will ask myself: have I helped to create a better, simpler and lighter regulatory framework for doing business in the EU that works? And have I blocked some of the more extravagant ideas that business might otherwise have been burdened with? That is my personal benchmark. Europe has to strive to be the best in the world, and nothing less. Strive to have a better regulatory framework than our competitors – business driven, prudentially sound, and sensible – with responsible levels of investor protection. We should aim to be the model for the emerging capital markets – and be open to innovative ways to cooperate with China, India, Brazil. And of course the United States.<sup>35</sup>

Notice the reference at the end of this passage to co-operation with the US. The US'

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<sup>34</sup> Allen B. Morgan, Jr., SIA Chairman, *Building Investor Confidence*, Speech to the Securities Industry Association Annual Conference (Nov. 7, 2002) available at [http://archives2.sifma.org/speeches/html/morgan\\_meeting02.html](http://archives2.sifma.org/speeches/html/morgan_meeting02.html) .The SIA was a trade association for securities firms which merged with the Bond Market Association, another financial industry trade association, to become SIFMA. See <http://www.sifma.org/> .

<sup>35</sup> See Charlie McCreevy, European Commissioner for Internal Market and Services, Towards a Better Regulated European Capital Market, London Stock Exchange Christmas Lunch, London, 16 December 2005 at <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/05/793&format=HTML&aged=0&language=EN&guiLanguage=fr>

Sarbanes-Oxley Act of 2002<sup>36</sup> included a number of provisions which adversely affected foreign issuers of securities which had issued their securities in the US. After pressure from the EU the SEC worked to mitigate these harsh effects, and (again in 2005) Charlie McCreevy talked positively about the EU/US relationship:

We have an excellent financial markets relationship with the United States. No tension. Simple matter of fact meetings. Got a regulatory problem? Then let's sit down and work it through. That's our approach. Informal. Without the bureaucratic baggage. Without the "after you Cecil" language. Straight talking to resolve problems. And it works. This week we have seen another positive indicator – a point we have been consistently raising with them – that the US SEC has made a proposal to resolve the US deregistration problem. So the Hotel California is beginning to open and foreign issuers may be able to leave more easily. The SEC has delivered these proposals bang on time (i.e. exactly when they said they would). We are checking the details with our industry, but it is certainly a positive signal showing the willingness of our American counterparts to find a solution.<sup>37</sup>

**These passages address some important issues in financial regulation. Some regulation is necessary to address market failures, but too much regulation imposes costs on financial firms. The firms will be able to pass some of these costs on to their customers but high levels of regulatory costs may discourage customers from transacting with financial firms. Scandals tend to produce new rules as politicians and regulators want to appear to be taking the problems seriously. And new rules introduced in a rush may not always be the best rules to address the problems. Sometimes new rules are not really what is needed (although extra enforcement efforts may be desirable). Who should make the rules - corporates, financial firms, trade associations, regulators (state or federal), or legislatures? Does business driven regulation mean that businesses should make the rules?**

**Do you think that different jurisdictions should try to compete with each other in terms of regulation? Is this sort of competition desirable? How does this competition fit in with the sort of negotiation that McCreevy describes?**

We will look in detail at some of the current issues in financial regulation later.

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<sup>36</sup> Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745, July 30, 2002.

<sup>37</sup> *Id.*



Regulators have been focusing on a range of safety and soundness issues with respect to banks, especially relating to liquidity and risk concentrations, and on issues relating to complex financial instruments (and the failure of credit rating agencies to rate such instruments accurately). The current problems illustrate the interconnection of the financial markets in different parts of the world. **Már Gudmundsson** said in a speech in September 2008:<sup>38</sup>

The current global financial crisis has now lasted more than a year, with no immediate end in sight. The crisis was triggered by increasing defaults on subprime mortgages and the turn of the housing cycle in the United States. Subsequently, the credit ratings of structured products, wholly or partly based on these mortgages, were significantly downgraded, raising uncertainty about the valuation of such products.

It was at this point that the banks at the centre of the financial system were hit much more speedily than most had envisaged before the crisis. Thus the drying-up of the market for asset-backed commercial paper created pressure on banks' funding liquidity. The reason was that the banks needed, for legal or reputational reasons, to provide their special purpose vehicles with liquidity or to bring them back onto their balance sheets. Thus, the banks needed to make more use of their own funding liquidity at the same time as their future liquidity needs were becoming both bigger and more uncertain. On top of this, they were becoming more uncertain about the creditworthiness of other banks, as they did not know where the exposure to the toxic subprime and structured product stuff was, or which banks might face problems because they would be forced into a distressed sale of assets due to a lack of funding liquidity. The result was a generalised hoarding of funding liquidity, which might have been rational from the standpoint of individual banks but was disastrous for the system as a whole.

This hoarding of funding liquidity made the crisis come to the fore in the drying-up of market liquidity in interbank money markets in the United States and in Europe on 9 August last year. This in turn prompted central banks in these regions to inject massive amounts of liquidity in order to stop money market interest rates from rising far above targeted levels.

We now know that this was only the beginning. What at first seemed mostly to be a US problem is now increasingly a global problem. What at first seemed to be valuation problems in specific segments of financial markets have turned into a broader-based downturn in asset prices. What at first seemed to be a liquidity problem has turned into major losses and writedowns of bank capital. We are currently in a phase of this crisis where significant parts of the financial system in advanced economies are being forced to reduce their assets relative to capital, that is, to reduce what is called

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<sup>38</sup> See <http://www.bis.org/speeches/sp081119.htm> . At the time he was Deputy Head of the Monetary and Economic Department of the BIS (Bank for International Settlements) and he became Governor of the Central Bank of Iceland in 2009.

leverage. The reason is that the current level of leverage of many financial institutions implies a higher level of risk than they can manage in this environment of higher funding costs, increased volatility of most financial prices and more uncertainty. The deleveraging can take place through the raising of additional capital, which is currently becoming more difficult, or the disposal of assets and use of the proceeds to repay debt. However, a deleveraging of the whole financial sector, as distinct from individual institutions in normal market conditions, is a painful process involving asset price deflation and a lack of market liquidity.

The impairment of the wholesale money market along with higher funding costs and shorter available maturities has made many business models untenable. Those relying on short-term funding in wholesale money markets have been particularly vulnerable. This was the undoing of Northern Rock and contributed to the downfall of investment banks. One result of the decline of wholesale funding has been a significantly higher degree of competition for deposits, particularly in Europe.

The metamorphosis of the crisis from its initial stages to now is easier to understand when we realise that it had deeper causes than the faults in US subprime loan origination and the associated securitisation process. The crisis was preceded by a period of low real interest rates and easy access to credit, which fuelled risk-taking and debt accumulation. In the United States, it was the case both for households and for the financial sector itself. However, although the increased indebtedness of the US household sector was plain for everybody to see, the increased leverage of the financial sector was somewhat hidden. One reason was that the leverage was partly accumulating in what is now being called the shadow banking system. Another reason was that the focus on risk metrics like value-at-risk and the use of short time series as inputs allowed the low recent volatility of asset prices to mask the increase in leverage.

In the United States, easy credit conditions were made even more so by global current account imbalances and the willingness of foreign governments to finance the US current account deficit. Easy monetary policy in the aftermath of the bursting of the tech stock bubble in 2001 might also have contributed at the margin, although easy credit preceded it.

Last but not least, financial innovation contributed to debt accumulation. In particular, the originate-to-distribute model made it possible to originate loans - especially mortgages - to households, securitise them in large quantities, slice and dice them into differently rated tranches, and then sell them all over the world to both risk-averse and risk-seeking investors. The effect was that loan origination was less constrained by the balance sheet capacity of banks.

One result of this setup was that risk was apparently spread away from the institutions that are critical for the overall functioning and stability of the financial system, which should be good from the standpoint of financial stability. However, as it turned out, the distribution was less than met the eye, as the asset-backed securities were often held by special purpose vehicles closely associated with the banks originating them. Some commentators have for this reason called the arrangement "originate and pretend to distribute". Furthermore, as the value of structured products was potentially unstable and would become very uncertain at the first sign of stress and illiquidity in financial markets, what was distributed was not only risk, but also uncertainty and fear.

The upshot of all of this was the underpricing of risk. This underpricing was widely recognised in the central banking community, and by others, and was expected to result in significant repricing, which would in all probability be associated with lower asset values and a downturn in the credit cycle. What nobody knew, of course, was the timing of this repricing; nor did anyone anticipate the speed and ferocity of the change or the degree to which it would, in the first round, affect the core of the financial system.

The “shadow banking system” Gudmundsson refers to involves non-bank institutions which behave like banks, borrowing short (issuing commercial paper, which is short term debt) and lending long. These non-bank entities are not regulated in the same way that banks are, and have not been part of deposit insurance systems, nor have they had access to lender of last resort facilities available to banks, although AIG was bailed out by the US Government in 2008. The **Congressional Oversight Panel** criticized this bailout:

At its peak, American International Group (AIG) was one of the largest and most successful companies in the world, boasting a AAA credit rating, over \$1 trillion in assets, and 76 million customers in more than 130 countries. Yet the sophistication of AIG.s operations was not matched by an equally sophisticated risk-management structure. This poor management structure, combined with a lack of regulatory oversight, led AIG to accumulate staggering amounts of risk, especially in its Financial Products subsidiary, AIG Financial Products (AIGFP). Among its other operations, AIGFP sold credit default swaps (CDSs), instruments that would pay off if certain financial securities, particularly those made up of subprime mortgages, defaulted. So long as the mortgage market remained sound and AIG.s credit rating remained stellar, these instruments did not threaten the company’s financial stability.

The financial crisis, however, fundamentally changed the equation on Wall Street. As subprime mortgages began to default, the complex securities based on those loans threatened to topple both AIG and other long-established institutions. During the summer of 2008, AIG faced increasing demands from their CDS customers for cash security . known as collateral calls totaling tens of billions of dollars. These costs put AIG.s credit rating under pressure, which in turn led to even greater collateral calls, creating even greater pressure on AIG’s credit.

By early September, the problems at AIG had reached a crisis point. A sinkhole had opened up beneath the firm, and it lacked the liquidity to meet collateral demands from its customers. In only a matter of months AIG.s worldwide empire had collapsed, brought down by the company’s insatiable appetite for risk and blindness to its own liabilities.

AIG sought more capital in a desperate attempt to avoid bankruptcy. When the company could not arrange its own funding, Federal Reserve Bank of New York President Timothy Geithner, who is now Secretary of the Treasury, told AIG that the government would attempt to orchestrate a privately funded solution in coordination with JPMorgan Chase and Goldman Sachs. A day later, on

September 16, 2008, FRBNY abandoned its effort at a private solution and rescued AIG with an \$85 billion, taxpayer-backed Revolving Credit Facility (RCF). These funds would later be supplemented by \$49.1 billion from Treasury under the Troubled Asset Relief Program (TARP), as well as additional funds from the Federal Reserve, with \$133.3 billion outstanding in total. The total government assistance reached \$182 billion....

The government failed to exhaust all options before committing \$85 billion in taxpayer funds. In previous rescue efforts, the federal government had placed a high priority on avoiding direct taxpayer liability for the rescue of private businesses. For example, in 1998, the Federal Reserve pressed private parties to prevent the collapse of Long-Term Capital Management, but no government money was used. In the spring of 2008, the Federal Reserve arranged for the sale of Bear Stearns to JPMorgan Chase. Although the sale was backed by \$28.2 billion of federal loans, much of the risk was borne by private parties.

With AIG, the Federal Reserve and Treasury broke new ground. They put U.S. taxpayers on the line for the full cost and the full risk of rescuing a failing company.

During the Panel's meetings, the Federal Reserve and Treasury repeatedly stated that they faced a "binary choice": either allow AIG to fail or rescue the entire institution, including payment in full to all of its business partners. The government argues that AIG's failure would have resulted in chaos, so that a wholesale rescue was the only viable choice. The Panel rejects this all-or-nothing reasoning. The government had additional options at its disposal leading into the crisis, although those options narrowed sharply in the final hours before it committed \$85 billion in taxpayer dollars.

For example, the federal government could have acted earlier and more aggressively to secure a private rescue of AIG. Government officials, fully aware that both Lehman Brothers and AIG were on the verge of collapse, prioritized crafting a rescue for Lehman while they left AIG to attempt to arrange its own funding. By the time the Federal Reserve Bank reversed that approach, leaving Lehman to collapse into bankruptcy without help and concluding that AIG posed a greater threat to financial stability, time to explore other options was short. The government then put the efforts to organize a private AIG rescue in the hands of only two banks, JPMorgan Chase and Goldman Sachs, institutions that had severe conflicts of interest as they would have been among the largest beneficiaries of a taxpayer rescue.

When that effort failed, the Federal Reserve decided not to press major lenders to participate in a private deal or to propose a rescue that combined public and private funds. As Secretary Geithner later explained to the Panel it would have been irresponsible and inappropriate in his view for a central banker to press private parties to participate in deals to which the parties were not otherwise attracted. Nor did the government offer to extend credit to AIG only on the condition that AIG negotiate discounts with its financial counterparties. Secretary Geithner later testified that he believed that payment in full to all AIG counterparties was necessary to stop a panic. In short, the government chose not to exercise its substantial negotiating leverage to protect taxpayers or to maintain basic market discipline.

There is no doubt that orchestrating a private rescue in whole or in part would have been a

difficult – perhaps impossible – task, and the effort might have met great resistance from other financial institutions that would have been called on to participate. But if the effort had succeeded, the impact on market confidence would have been extraordinary, and the savings to taxpayers would have been immense. Asking for shared sacrifice among AIG's counterparties might also have provoked substantial opposition from Wall Street. Nonetheless, more aggressive efforts to protect taxpayers and to maintain market discipline, even if such efforts had failed, might have increased the government's credibility and persuaded the public that the extraordinary actions that followed were undertaken to protect them.

The rescue of AIG distorted the marketplace by transforming highly risky derivative bets into fully guaranteed payment obligations. In the ordinary course of business, the costs of AIG's inability to meet its derivative obligations would have been borne entirely by AIG's shareholders and creditors under the well-established rules of bankruptcy. But rather than sharing the pain among AIG's creditors, an outcome that would have maintained the market discipline associated with credit risks, the government instead shifted those costs in full onto taxpayers out of a belief that demanding sacrifice from creditors would have destabilized the markets. The result was that the government backed up the entire derivatives market, as if these trades deserved the same taxpayer backstop as savings deposits and checking accounts.

One consequence of this approach was that every counterparty received exactly the same deal: a complete rescue at taxpayer expense. Among the beneficiaries of this rescue were parties whom taxpayers might have been willing to support, such as pension funds for retired workers and individual insurance policy holders. But the across-the-board rescue also benefitted far less sympathetic players, such as sophisticated investors who had profited handsomely from playing a risky game and who had no reason to expect that they would be paid in full in the event of AIG's failure. Other beneficiaries included foreign banks that were dependent on contracts with AIG to maintain required regulatory capital reserves. Some of those same banks were also counterparties to other AIG CDSs.

Throughout its rescue of AIG, the government failed to address perceived conflicts of interest. People from the same small group of law firms, investment banks, and regulators appeared in the AIG saga in many roles, sometimes representing conflicting interests. The lawyers who represented banks trying to put together a rescue package for AIG became the lawyers to the Federal Reserve, shifting sides within a matter of minutes. Those same banks appeared first as advisors, then potential rescuers, then as counterparties to several different kinds of agreements with AIG, and ultimately as the direct and indirect beneficiaries of the government rescue. The composition of this tightly intertwined group meant that everyone involved in AIG's rescue had the perspective of either a banker or a banking regulator. These entanglements created the perception that the government was quietly helping banking insiders at the expense of accountability and transparency....

The government's actions in rescuing AIG continue to have a poisonous effect on the marketplace. By providing a complete rescue that called for no shared sacrifice among AIG's creditors, the Federal Reserve and Treasury fundamentally changed the relationship between the

government and the country's most sophisticated financial players. Today, AIG enjoys a five-level improvement in its credit rating based solely on its access to government funding on generous terms. Even more significantly, markets have interpreted the government's willingness to rescue AIG as a sign of a broader implicit guarantee of "too big to fail" firms. That is, the AIG rescue demonstrated that Treasury and the Federal Reserve would commit taxpayers to pay any price and bear any burden to prevent the collapse of America's largest financial institutions, and to assure repayment to the creditors doing business with them. So long as this remains the case, the worst effects of AIG's rescue on the marketplace will linger...

Through a series of actions, including the rescue of AIG, the government succeeded in averting a financial collapse, and nothing in this report takes away from that accomplishment. But this victory came at an enormous cost. Billions of taxpayer dollars were put at risk, a marketplace was forever changed, and the confidence of the American people was badly shaken.<sup>39</sup>

Post-crisis, policy-makers are considering how best to plan for crisis management for the financial sector.<sup>40</sup>

### 3.0 INSTITUTIONS OF TRANSNATIONAL FINANCIAL REGULATION

Rules of financial regulation, and the rules of private law which help to constitute cross-border transactions, are artefacts of domestic legal systems. However, activity which crosses territorial boundaries raises questions about what law applies, and how law applies to those transactions. Domestic regulators, legislatures and courts are actors in transnational financial law because of cross-border transactions.

Parties to transnational transactions can choose which rules of contract law apply to their transactions, subject to the risk that in a particular jurisdiction (with which the transaction is connected in some way) some rules of contract law or non-contract law will be treated as being mandatory and not able to be contracted around (for example, fiduciary duties, rules of securities regulation, and anti-trust law). Cross-border transactions raise issues of choice of law and jurisdiction, and domestic courts are involved in applying the relevant rules. Some cross-border transactions include arbitration provisions. Parties to transnational transactions

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<sup>39</sup> Congressional Oversight Panel, The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy, 7-10 (Jun. 10, 2010) at <http://cop.senate.gov/documents/cop-061010-report.pdf>.

<sup>40</sup> See, e.g., EU Commission Communication on a New Eu Framework for Crisis Management in the Financial Sector, COM(2010) 579 (Oct. 20, 2010) at [http://ec.europa.eu/internal\\_market/bank/docs/crisis-management/framework/com2010\\_579\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf)

can avoid the application of certain legal rules by avoiding connections with certain jurisdictions.

Financial regulators based in different jurisdictions increasingly work together to regulate transnational financial activity, through Memoranda of Understanding (MOUs), through transnational standard-setting organizations, and in the context of supervision and enforcement.

At the supranational level there are international organizations which have an interest in financial markets and financial regulation. Different organizations have different mandates and structures. Some inter-governmental organizations, such as the Basle Committee on Banking Supervision, IOSCO (International Organisation of Securities Commissions), and the IAIS (International Association of Insurance Supervisors) are essentially collaborative, technocratic organizations with the power to develop non-binding recommendations, principles and standards. The Basle Committee on Banking Supervision (BCBS) describes itself as follows:

The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the Committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. In this regard, the Committee is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision.

The Committee's members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.<sup>41</sup> The present Chairman of the Committee is Mr Nout Wellink, President of the Netherlands Bank.

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<sup>41</sup> Of these 27 members, 14 were invited to join the Committee during 2009. See BIS, Press Release, The Basel Committee Broadens its Membership (Jun. 10, 2009) at <http://www.bis.org/press/p090610.htm> (announcing invitation to join the Committee to Argentina, Indonesia, Saudi Arabia, South Africa, Turkey, Hong Kong and Singapore); BIS, Press Release, Expansion of Membership Announced by the Basel Committee (Mar. 13, 2009) at <http://www.bis.org/press/p090313.htm> (announcing invitation to join the Committee to Australia, Brazil, China, India, Korea, Mexico and Russia). Before 2009 the Committee had a much more limited membership. The expansion of membership was designed to enhance the perceived legitimacy of the Committee's work. Compare the IMF's moves to change its governance arrangements referred to at note 3 above.

The Committee encourages contacts and cooperation among its members and other banking supervisory authorities. It circulates to supervisors throughout the world both published and unpublished papers providing guidance on banking supervisory matters. Contacts have been further strengthened by an International Conference of Banking Supervisors (ICBS) which takes place every two years.

The Committee's Secretariat is located at the Bank for International Settlements in Basel, Switzerland, and is staffed mainly by professional supervisors on temporary secondment from member institutions. In addition to undertaking the secretarial work for the Committee and its many expert sub-committees, it stands ready to give advice to supervisory authorities in all countries. Mr Stefan Walter is the Secretary General of the Basel Committee.<sup>42</sup>

In contrast to intergovernmental/inter-regulator organizations, the European Union has supranational institutions which function like a legislature, creating rules which are binding on its Member States and, in some circumstances, on people and businesses within those Member States.<sup>43</sup> Traditionally the EU has legislated for financial regulation using directives which require implementation in the Member States and thus function as instructions to the Member States to introduce rules which give effect to the provisions of the directives. More recently the EU has moved to trying to use regulations in some cases.<sup>44</sup> Regulations take effect directly within the legal systems of the Member States without any need for, or possibility of, implementing action by the Member States (like a federal statute). And as of the beginning of 2011, the EU has a European Systemic Risk Board and a set of new supervisory authorities (basically a reworking of existing institutions). Michel Barnier the Internal Market Commissioner, stated:

The date of 1st January 2011 marks a turning point for the European financial sector. Today, three new European Authorities for the supervision of financial activities – for banks, markets and insurances and pensions respectively - start their work a few days after the launch of the

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<sup>42</sup> See <http://www.bis.org/bcbs/index.htm> .

<sup>43</sup> The EU with its complex institutional structures has a closer resemblance to a federal government than other supranational standard-setters, and has focused greater attention on issues of governance and consultation. See, e.g., EU Commission, White Paper on European Governance, COM(2001) 428 final (Jul. 25, 2001); EU Commission, Communication from the Commission, Towards a reinforced culture of consultation and dialogue - General principles and minimum standards for consultation of interested parties by the Commission, 10, COM (2002) 704 final (Dec. 11, 2002).

<sup>44</sup> See, e.g., Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, OJ No. L 302/ 1 (Nov. 17, 2009) at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0001:0031:EN:PDF> .



European Systemic Risk Board.

The crisis highlighted only too clearly the limits and sometimes the failings of our supervision system in Europe. The accumulation of excessive risk was not detected. Surveillance and supervision were not effective in time. When transnational financial institutions faced problems, the coordination between national authorities was far from optimal, and this even though these institutions are more and more numerous.

Europe is learning the lessons from the crisis and that is why today, it is giving itself a new apparatus of surveillance and supervision. To detect problems early and to act in time – in a coordinated and efficient way. This new structure are the control tower and the radar screens that the financial sector needs,

The European Systemic Risk Board will monitor the entire financial sector, to identify potential problems which could contribute to a crisis in the future.

It will work in close cooperation with the new European Supervisory Authorities. These will not replace national authorities and our objective is not to transfer the control of financial institutions to the EU. Our aim is to create a network of authorities, where the national authorities are responsible for the daily surveillance, and the European authorities – using the expertise of the national authorities and working hand in hand with them – are responsible for coordination, monitoring and if need be arbitration between national authorities, and will contribute to the harmonisation of technical rules applicable to financial institutions.

With this new framework of financial supervision in Europe in place, we are putting into effect in practical terms the lessons learnt from the crisis. This framework is at the heart of the ongoing financial reforms. It is the foundation on which all other reforms are based – for example those for credit rating agencies, hedge funds, derivatives, stress tests etc. Together, these measures will enhance consumer protection. And they will contribute to ensuring the taxpayer is not again the first in line to bear the costs of a crisis.

This move forward also demonstrates that Europe is leading the way and upholding its international commitments. These new authorities will work with others across the world to ensure better global supervision.<sup>45</sup>

The IMF is a treaty-based international organization which was founded in 1944 to govern the international monetary system to assure exchange rate stability and encourage IMF members to do away with exchange restrictions.<sup>46</sup> The IMF lends money to its member countries when they have needs for funding they are not able to meet in the financial

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<sup>45</sup> EU Commission, a Turning Point for the European Financial Sector, MEMO/11/1 (Jan. 1, 2011).

<sup>46</sup> You can find the Articles of Agreement of the International Monetary Fund at <http://www.imf.org/external/pubs/ft/aa/index.htm> .

markets, and recent events have increased demand for funds from the IMF. The IMF has funds available for crisis lending: Iceland benefitted from this facility.<sup>47</sup> As part of its lending programs, the IMF examines the economies of the countries to which it lends, including their bank regulatory systems.<sup>48</sup> The IMF's interest in monitoring the financial soundness of its members, especially of its borrowers, gives it an interest in regulation as a mechanism for promoting financial stability. The IMF has been criticized with respect to the requirements it imposes on borrowing countries. For example, commentators have argued that requiring privatization can be harmful: requiring privatization of the water industry tends to lead to charges for the provision of clean water which means that poor people do not have access to clean water.<sup>49</sup> The IMF has recently been working to address some of the concerns about its role by emphasizing transparency as an accountability mechanism.<sup>50</sup>

Ten years before the global financial crisis, the Asian financial crisis<sup>51</sup> led to the

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<sup>47</sup> See, e.g., IMF, IMF Completes First Review Under Stand-By Arrangement with Iceland, Extends Arrangement, and Approves US\$167.5 Million Disbursement, Press Release No. 09/375 (Oct. 28, 2009) at <http://www.imf.org/external/np/sec/pr/2009/pr09375.htm> ; IMF, Iceland: Financial System Stability Assessment—Update, IMF Country Report No. 08/368 (Dec. 2008) available at <http://www.imf.org/external/pubs/ft/scr/2008/cr08368.pdf> .

<sup>48</sup> See, e.g., *id.* And consider the comments of Poul Thomsen, the IMF's mission chief for Iceland: "Iceland allowed a very oversized banking system to develop—a banking system that significantly outstripped the authorities' ability to act as a lender of last resort when the system ran into trouble. Only a few years ago, Iceland had a banking system that was the normal size. But after the privatization of the banking sector was completed in 2003, the banks increased their assets from being worth slightly more than 100 percent of GDP to being worth close to 1,000 percent of GDP. When confidence problems intensified this fall, Iceland was one of the first victims because the market realized that the banking system was far too big relative to the size of the economy. As investors started to pull out, it quickly spilled over into trouble for the Icelandic króna. Within a week the three banks collapsed, the króna's value dropped by more than 70 percent, and the stock market lost more than 80 percent of its value. For a small economy that is totally dependent on imports, this was a crisis of huge proportions." Camilla Andersen, Iceland Gets Help to Recover From Historic Crisis, IMF Survey Online (Dec. 2, 2008) available at <http://www.imf.org/external/pubs/ft/survey/so/2008/int111908a.htm> .

<sup>49</sup> See e.g., [http://www.jubileeusa.org/fileadmin/user\\_upload/Resources/Policy\\_Archive/Debt\\_and\\_Water\\_2004.pdf](http://www.jubileeusa.org/fileadmin/user_upload/Resources/Policy_Archive/Debt_and_Water_2004.pdf).

<sup>50</sup> See, e.g., IMF, Transparency is Key to Accountability (Jan. 11, 2010) at <http://www.imf.org/external/np/exr/cs/news/2010/cso110.htm> .

<sup>51</sup> See, e.g., IMF, Recovery from the Asian Crisis and the Role of the IMF (Jun. 2000) at <http://www.imf.org/external/np/exr/ib/2000/062300.htm> ("The crises that began in Thailand with a series of speculative attacks on the baht unfolded after several decades of outstanding economic performance in Asia. Although the circumstances varied among the countries concerned, the difficulties stemmed primarily from a combination of macroeconomic imbalances (even though government budgets were broadly in balance and inflation rates were modest), external developments, and weakness in financial

development of the Financial Stability Forum (FSF), which was established in 1999. The FSF was designed to bring together representatives of national central banks, supervisory authorities and treasury departments, international financial institutions (e.g. the IMF and the World Bank), international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank. In 2009 the FSF was reborn as the Financial Stability Board:<sup>52</sup>

In November 2008, the Leaders of the G20 countries called for a larger membership of the FSF. A broad consensus emerged in the following months towards placing the FSF on stronger institutional ground with an expanded membership - to strengthen its effectiveness as a mechanism for national authorities, standard setting bodies and international financial institutions to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability.

As announced in the G20 Leaders Summit of April 2009, the expanded FSF was re-established as the Financial Stability Board (FSB) with a broadened mandate to promote financial stability.<sup>53</sup>

In April 2009 the **G20**<sup>54</sup> issued a **Declaration on Strengthening the International Financial System** which stated:

We, the Leaders of the G20, have taken, and will continue to take, action to strengthen regulation and supervision in line with the commitments we made in Washington to reform the regulation of the financial sector. Our principles are strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets and reinforcing international cooperation.... In particular, we have agreed the following major reforms.

We have agreed that the Financial Stability Forum should be expanded, given a broadened mandate to promote financial stability, and re-established with a stronger institutional basis and enhanced

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and corporate systems. The external imbalances were a reflection both of strong private capital inflows and of high domestic private investment rates, and were exacerbated, prior to the crisis, by appreciation of the U.S. dollar to which the currencies of the countries concerned were formally or informally pegged.”)

<sup>52</sup> See <http://www.financialstabilityboard.org/> .

<sup>53</sup> <http://www.financialstabilityboard.org/about/history.htm> .

<sup>54</sup> The G20 comprises Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, Republic of Korea, Turkey, United Kingdom, United States of America and the EU. See [http://www.g20.org/about\\_what\\_is\\_g20.aspx](http://www.g20.org/about_what_is_g20.aspx) . Note that France, Germany, Italy and the UK are all members of the EU.

capacity as the Financial Stability Board (FSB).

The FSB will:

- assess vulnerabilities affecting the financial system, identify and oversee action needed to address them;
- promote co-ordination and information exchange among authorities responsible for financial stability;
- monitor and advise on market developments and their implications for regulatory policy;
- advise on and monitor best practice in meeting regulatory standards;
- undertake joint strategic reviews of the policy development work of the international Standard Setting Bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps;
- set guidelines for, and support the establishment, functioning of, and participation in, supervisory colleges, including through ongoing identification of the most systemically important cross-border firms;
- support contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and
- collaborate with the IMF to conduct Early Warning Exercises to identify and report to the IMFC and the G20 Finance Ministers and Central Bank Governors on the build up of macroeconomic and financial risks and the actions needed to address them.

Members of the FSB commit to pursue the maintenance of financial stability, enhance the openness and transparency of the financial sector, and implement international financial standards (including the 12 key International Standards and Codes), and agree to undergo periodic peer reviews, using among other evidence IMF / World Bank public Financial Sector Assessment Program reports. The FSB will elaborate and report on these commitments and the evaluation process.

We welcome the FSB's and IMF's commitment to intensify their collaboration, each complementing the other's role and mandate.<sup>55</sup>

The G20 also agreed to strengthen international co-operation, prudential regulation, to ensure systemically important institutions are subject to regulation, "to ensure compensation structures are consistent with firms' long-term goals and prudent risk taking," to deal with tax havens and territories which do not comply with money laundering controls, to improve accounting standards, and to regulate credit rating agencies more effectively.

The World Bank does not have a specific focus on financial regulation, although it has in recent years been interested in financial law and corporate governance as aspects of

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<sup>55</sup> G20 statements are available from [http://www.g20.org/pub\\_communiques.aspx](http://www.g20.org/pub_communiques.aspx).

governance seen as crucial to economic development.<sup>56</sup> A 2008 working paper states:

The process of globalization and financial development has been prone to crises. Over the long run, financial development is expected to support economic growth and poverty reduction. But, along the way, even relatively mature financial systems are vulnerable to systemic banking crises, cycles of booms and busts, and financial volatility. This appears to be partly intrinsic and partly due to policy mistakes. It arises as banks expand and capital markets generate new financial products. This entails new, unfamiliar, risks for financial intermediaries and regulators. Furthermore, as countries become more open to capital flows, crises are more easily transmitted across borders. The positive long-run relationship between financial development and growth coexists with a negative short-run relationship through financial fragility...

The most direct channel linking the developed world to the financial crisis emanating from the developed world in 2008 is through exposure to assets that are at the heart of the crisis, notably (though not only) the sub-prime mortgages. However, the more important channels for most developing countries will probably be indirect, notably through trade (via declining demand for developing- country exports or declining export process, including commodities), investment (as external finance contracts) and remittances (also stemming from the recession in the developed world).<sup>57</sup>

Other UN agencies have been involved in the negotiation of treaties which have an impact on financial transactions. For example, UNCITRAL, the United Nations Model Commission on International Trade Law, has developed a Model Law on Cross-Border Insolvency,<sup>58</sup> and a Convention on the Assignment of Receivables in International Trade.<sup>59</sup>

Non-UN international organizations may also be involved in developing harmonized standards relevant to financial transactions. For example, Unidroit, the International Institute

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<sup>56</sup> See, e.g., Asli Demirgüç-Kunt & Ross Levine, Finance, Financial Sector Policies, and Long-run Growth, World Bank Policy Research Working Paper No. 4469 (Nov. 2008) available at [http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2008/01/07/000158349\\_20080107115116/Rendered/PDF/wps4469.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2008/01/07/000158349_20080107115116/Rendered/PDF/wps4469.pdf). See generally [www.worldbank.org/wbi/governance](http://www.worldbank.org/wbi/governance).

<sup>57</sup> The World Bank, Development Research Group, Lessons from World Bank Research on Financial Crises, 3-4, Policy Research Working Paper 4779 (Nov. 2008).

<sup>58</sup> See [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html). See also, e.g., <http://global.abiworld.org/>.

<sup>59</sup> See [http://www.uncitral.org/uncitral/en/uncitral\\_texts/payments/2001Convention\\_receivables.html](http://www.uncitral.org/uncitral/en/uncitral_texts/payments/2001Convention_receivables.html).

for the Unification of Private Law,<sup>60</sup> has developed a Convention on Substantive Rules for Intermediated Securities (securities held not directly by investors but indirectly through an intermediary such as a broker).<sup>61</sup> The OECD focuses on a range of issues relating to financial markets from general financial market trends<sup>62</sup> to corporate governance<sup>63</sup> and investor education.<sup>64</sup>

These interactions between domestic and supranational institutions can be seen as forming a system of multi-level governance or regulatory networks for financial market activity. Here is an excerpt from a paper discussing some of the issues that arise in multi-level systems:<sup>65</sup>

Over time, supranational standard-setters have begun to formalise their standard-setting processes, developing their practices for consulting on proposed standards, and even establishing consultation policies.<sup>66</sup> However, the different organizations approach consultation and the reporting of the results of consultation differently,<sup>67</sup> and there is, so far, no harmonised supranational administrative law.<sup>68</sup> Consultation processes which exclude groups which are affected by harmonised rules because of a

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<sup>60</sup> <http://www.unidroit.org/dynasite.cfm>

<sup>61</sup> Convention on Substantive Rules for Intermediated Securities (Geneva, 2009) at <http://www.unidroit.org/english/conventions/2009intermediatedsecurities/main.htm> .

<sup>62</sup> [http://www.oecd.org/document/36/0,3343,en\\_2649\\_34849\\_1962020\\_1\\_1\\_1\\_37467,00.html](http://www.oecd.org/document/36/0,3343,en_2649_34849_1962020_1_1_1_37467,00.html)

<sup>63</sup> [http://www.oecd.org/topic/0,3373,en\\_2649\\_34813\\_1\\_1\\_1\\_1\\_37467,00.html](http://www.oecd.org/topic/0,3373,en_2649_34813_1_1_1_1_37467,00.html)

<sup>64</sup> See, e.g., OECD, Draft Good Practices on Financial Education and Awareness Relating to Credit (2008) available at <http://www.oecd.org/dataoecd/57/59/41804595.pdf> .

<sup>65</sup> Caroline Bradley, Financial Trade Associations and Multilevel Regulation. A version of this paper was published in Ramses Wessel, Andreas Follesdal & Jan Wouters eds., *Multilevel Regulation and the EU: The Interplay between Global, European and National Normative Processes* (2008) (footnote numbering adjusted for this document).

<sup>66</sup> See, e.g., IOSCO, Executive Committee, IOSCO Consultation Policy And Procedure, (Apr. 2005) available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD197.pdf> . Cf. R. D. Kelemen & Eric C. Sibbitt, *The Globalization of American Law*, 58 INT'L ORG. 103 (2004)

<sup>67</sup> See generally, e.g., C. Bradley, *Private International Law-Making for the Financial Markets*, 29 FORDHAM INT'L L. J. 127, 140-154 (2005).

<sup>68</sup> See, e.g., B. Kingsbury, N. Krisch, and R. B. Stewart, *The Emergence of Global Administrative Law*, 68 LAW AND CONTEMPORARY PROBLEMS 15, 16 (2005) (noting "an accountability deficit in the growing exercise of transnational regulatory power.")

lack of transparency,<sup>69</sup> or because the issues are framed in ways which make the views of affected groups seem irrelevant, lack legitimacy. Consumers and the organisations which represent their interests are more likely than financial firms to be excluded from effective participation in supranational standard-setting due to the combined effects of opaque processes, framing, and lack of resources.

Some harmonised rules are set out in binding legal instruments, others are only hortatory. Even the EU's binding harmonisation measures sometimes leave to the Member States some discretion about how to implement the directives within their domestic legal systems.<sup>70</sup> Non-binding standards developed by bodies such as IOSCO may be implemented differently by different states, or may not be implemented at all.<sup>71</sup> However, even formally hortatory standards derive greater force, and become harder for domestic legislators and regulators to ignore, because international financial institutions (IFIs) such as the IMF encourage governments to adopt these standards.<sup>72</sup>

Financial regulation involves complex issues of regulatory jurisdiction, in which jurisdiction is allocated horizontally between authorities in different territorial areas,<sup>73</sup> and vertically between authorities at different hierarchical levels within states, and at the supranational (regional or global) levels.<sup>74</sup> Within a domestic legal system the source for a rule of financial regulation may be sub-national, national, or supranational. Rules for the allocation of regulatory jurisdiction are established in

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<sup>69</sup> Cf. EU Commission, Green Paper: European Transparency Initiative, COM (2006) 194, May 3, 2006.

<sup>70</sup> Firms have suggested that the UK is too prone to "gold-plate" its rules: going further than is required by the directives. Cf. Financial Services Authority (hereafter "FSA"), *Better Regulation Action Plan*, London: FSA, December 2005, at p. 6 ("Our basic approach is to 'copy out' the text in our Handbook, adding interpretive guidance where that will be helpful. This avoids placing unintended additional obligations on firms. We will not gold-plate EU requirements. We will only add additional requirements when these are justified in their own right.")

<sup>71</sup> See, e.g., D. E. Alford, *Core Principles for Effective Banking Supervision: an Enforceable International Financial Standard?*, 28 B. C. INT'L & COMP. L. REV. 237, 286 (2005) ("because the agreements are not legally enforceable, nations can vary in their own interpretation and implementation of the standards.")

<sup>72</sup> See, e.g., *idem* at pp. 286-289.

<sup>73</sup> In some states, such as the US, jurisdiction is also splintered among different functional regulators. See, e.g., H. M. Schooner and M. Taylor, *United Kingdom and United States Responses To the Regulatory Challenges of Modern Financial Markets*, 38 Tex. Int'l L. J. 317 (2003)

<sup>74</sup> The complex web of regulation includes a significant component of privately generated standards and codes and contracts which may have quasi-regulatory effects. See, e.g., Bradley, *loc. cit.* note [67](#) at pp. 158-179.

statutes and treaties, but there can be uncertainty about the proper interpretation of the rules.<sup>75</sup>

Standards which are formally harmonised at the supranational level usually need to be implemented within domestic regulatory systems. Implementation is sometimes multilayered and indirect. For example, the Basle Committee has developed capital adequacy standards for banks involved in international banking.<sup>76</sup> Within the EU, capital adequacy requirements are an aspect of harmonised regulation of credit institutions, and the EU's capital adequacy rules are being amended to reflect the new Basle standards.<sup>77</sup> Competent authorities within the Member States are responsible for adjusting domestic capital adequacy requirements to reflect the new Basle standards as reflected in EU implementing measures.<sup>78</sup>

Where domestic legislators and regulators have discretion about how they carry out implementation, there are usually multiple points for influencing the regulatory process. Many different actors have a stake in the outcomes of these multi-level or multi-stage regulatory processes, from financial firms and their advisors to corporate and individual consumers of financial services.<sup>79</sup> But some stakeholders are in a better position to influence regulatory outcomes because of superior financial and other resources.

Financial trade associations ("FTAs") and their members now take advantage of opportunities to influence regulatory policy within multi-level systems. In particular, FTAs use two rhetorical strategies that tend to promote the interests of their members and which work against the interests of consumers. The first of these strategies is "market protection rhetoric." In relation to rule-making at the domestic or supranational level, FTAs often invoke arguments that particular proposals will interfere with the proper functioning of the financial markets. Market protection rhetoric is based in claims of expertise and usually implies that those invoking it are in a unique position to understand

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<sup>75</sup> Cf. S. Issacharoff and C. M. Sharkey, *Backdoor Federalization*, 53 *UCLA L. Rev.*, 2006, p. 1353 at p. 1366 ("preemption battles have been largely confined to the realm of statutory interpretation.")

<sup>76</sup> BIS, Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version*, Basel: BIS, June 2006.

<sup>77</sup> See Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions, O.J. No. L177/1, June. 30, 2006. The Committee of European Banking Supervisors (hereafter CEBS) has sought comments on details of the implementation of the new rules. See, e.g., CEBS, *Consultation Paper on the Guidelines for a Common Approach to the Recognition of External Credit Assessment Institutions (ECAIS)*, CP07, London: CEBS, June 29, 2005.

<sup>78</sup> See, e.g., FSA, *Strengthening Capital Standards*, CP 05/03, London: FSA, January 2005.

<sup>79</sup> The decision-makers in the supranational bodies also have a stake in the regulatory process, as do legislators and regulators. Cf. Braithwaite & Drahos, *Global Business Regulation*, Cambridge: Cambridge University Press, 2000, at 23 ("Each regulatory domain has a distinct range of actors contending for victory at different sites.")



the market. Market protection rhetoric includes arguments for self-regulation based on expertise.

The FTAs' other routine strategy relies on "harmonisation rhetoric," which is invoked in the context of domestic regulatory action.<sup>80</sup> Harmonisation rhetoric involves an argument that the rules in one domestic jurisdiction should not be stricter than those in another. The argument appears in the context of implementation of supranational standards or rules (for example, arguments against gold-plating when implementing EU directives)<sup>81</sup> and also arises to oppose rules proposed by domestic regulators that lack a supranational source. Harmonisation rhetoric can be seen as a subset of market protection rhetoric because those who invoke it would argue that more onerous rules in one jurisdiction limit the ability of firms established there to compete with firms established elsewhere. Harmonisation rhetoric may also include arguments for self-regulation, on the basis that self-regulatory standards and codes may be able to operate more effectively across territorial boundaries than state-based regulation.<sup>82</sup>

Although the characterization of financial regulation as a system of multi-level governance is useful in some ways, and links to multi-level governance in other fields, the idea of multi-level governance does not fully capture the ways in which transnational financial regulation is developing:<sup>83</sup>

... it is useful to characterize transnational financial regulation as a series of intersections between different regulatory spheres rather than as a multi-layered regime for four sets of reason. First,

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<sup>80</sup> Harmonisation rhetoric is only necessary in the context of the development of supranational rules and standards in order to limit the discretion of the implementing authorities.

<sup>81</sup> See, e.g., S. Schaefer and E. Young, *Burdened by Brussels or the UK? Improving the Implementation of EU Directives*, London: Foreign Policy Centre, August 2006, at pp 10-11 ("Rules agreed at the EU level are vital for the proper functioning of the single market. But they can also hamper competitiveness and productivity if they add a differently sized burden in individual member states because they have been implemented in different ways. Gold-plating, as defined by an ongoing audit by HM Treasury, is part of a larger category of over-implementation which also includes double-banking or regulatory creep.")

<sup>82</sup> Cf. N. S. Poser, *The Stock Exchanges of the United States and Europe: Automation, Globalization and Consolidation*, 22 U. Penn. J. Int'l Econ. L. 497, 538 (2001) ("These are not rules promulgated by a government agency, but by contractual arrangements among the participants. This suggests that self-regulation has the ability to finesse the problems of national sovereignty and differing legal systems that stand in the way of developing and enforcing common governmental regulatory standards.")

<sup>83</sup> What follows is from Caroline Bradley, *Intersections and Layers in Financial Regulation* (April 2009 draft) (unpublished work in progress, although the full document is available at <http://beta.blenderlaw.umlaw.net/wp-content/uploads/2009/04/bradleylayers002.pdf>).

whereas constitutional or treaty-based systems explicitly or implicitly allocate the jurisdiction to make rules to different levels of the system, most transnational financial regulation involves the establishment of agreed, but formally non-binding, standards, rather than an allocation of jurisdiction to make rules. The relationships between the supranational bodies and nation states are qualitatively different from those between the states and their component entities. Second, characterizing the regulatory system as a system of layers may tend to generate normative conclusions about where jurisdiction to regulate financial activity should be exercised.<sup>84</sup> Thinking about regulatory spheres might be less likely to generate such a result. Third, the terminology of layers or levels tends to imply that the relevant issues involve vertical relationships, whereas thinking in terms of regulatory spheres invites us to think in terms of more complex, and more descriptively realistic, categories of relationship. Finally, any implication that transnational standard-setting is at the top of a regulatory hierarchy is problematic when transnational standard-setting is not subject to administrative law norms or mechanisms for judicial review, and where transnational standard-setters themselves set the principles by which they develop their standards.

The intersections I explore in this paper are those between governmental and non-governmental or private spheres; between the spheres of expertise and of politics; and between the domestic and foreign or international spheres....

Financial regulation has both governmental and non-governmental components. In the administrative state, regulators seek comments on regulatory proposals. Financial regulatory systems include self-regulatory organizations (SROs) as well as governmental regulators, and accommodate privately generated standards and codes. SROs are involved both in the generation of rules and in the enforcement of regulation. Courts interpret and apply standard form contracts generated by non-governmental bodies in ways that sometimes seem to be the equivalent of recognizing the law-making effect of actions of private actors.<sup>85</sup>

Private regulation of financial activity precedes governmental control:<sup>86</sup> exchanges have traditionally controlled the conduct of their members and were incorporated into governmental regulatory systems in order to make governmental regulation more palatable to market participants. A recent and voluminous literature on regulation has advocated a decentring of regulation and a move away from command and control forms of regulation. The financial crisis has for some policy-makers raised issues about the appropriate balance between self-regulation and governmental regulation.

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<sup>84</sup> Discussions of pre-emption and subsidiarity tend to assume that there is an appropriate location for jurisdiction with respect to a particular issue. But jurisdiction involves choices which are inherently political.

<sup>85</sup> For example, courts have recognized and given effect to standard form contracts and practices in the distressed debt market. See, e.g., *Bear Stearns Bank PLC v Forum Global Equity Ltd.* [2007] EWHC 1576 (Comm) at <http://www.bailii.org/ew/cases/EWHC/Comm/2007/1576.html>.

<sup>86</sup> See, e.g., Paul Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1457 (1997).

The term "self-regulation" has been used in different ways in different contexts,<sup>87</sup> and comparing and contrasting self-regulation and governmental regulation, and defining the relationships between them, are complex tasks. The official terminology that legislators and other governmental and inter-governmental actors use to describe a regulatory system is not always a reliable descriptor of the system, and may even be designed to allow different communities to interpret the balance between governmental and non-governmental authorities differently. For example, as part of its work on the development of transnational standards for securities regulation, IOSCO has focused on the role of credit rating agencies (CRAs) in analyzing the credit risk of issuers of securities. Although IOSCO has presented the work it has done with respect to developing principles and fundamentals for the regulation of CRAs as encouraging self-regulation, CRAs were only part of the story. The initial consultation document on fundamentals for CRA Codes of Conduct noted that it had been developed with input from CRAs.<sup>88</sup> But IOSCO is an organization of securities commissions; in seeking to develop rules for CRAs, IOSCO sought input from two other inter-governmental regulator organizations, the Basel Committee of Banking Supervisors, and the International Association of Insurance Supervisors.<sup>89</sup> The system developed for the "self-regulation" of CRAs involved standards developed through a mixed governmental and non-governmental process, to be implemented by CRAs but subject to the supervision of some domestic regulators.

The term "self-regulation" is inherently slippery and imprecise, combining two apparently conflicting ideas. It is a term which may disguise a regulatory structure in which there is more governmental control than market participants might think desirable, and more independence from governmental control than the public and, in particular retail consumers of financial services, might want. Statutory constraints on SROs limit self-regulation, allow governments to distance themselves from regulatory failures, and restructure the competitive landscape of markets.

Some non-governmental groups, such as exchanges and trade associations, exercise regulatory or quasi -regulatory authority. In addition, firms and their trade associations lobby to influence the development of regulation by governmental regulatory agencies. Financial firms and the trade associations which represent them have for some time used two inter-linked rhetorical strategies to influence the development of transnational financial regulation, which I have called

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<sup>87</sup> See Caroline Bradley, *Reconfiguring the Self in Self-Regulation* (Draft: October 5, 2008) available at <http://blenderlaw.umlaw.net/wp-content/uploads/2008/10/bradleyselfart008.pdf> (examining the concept of the self in self regulation).

<sup>88</sup> IOSCO, Code Of Conduct Fundamentals For Credit Rating Agencies, Consultation Report from the Technical Committee Chairmen Task Force on CRAs (Oct. 2004) available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD173.pdf> .

<sup>89</sup> *Id.*

harmonization rhetoric and market protection rhetoric.<sup>90</sup> Market protection rhetoric involves claims that governmental regulation should not interfere too much with market activity, and governments have been receptive to such arguments, for example when they have adopted Better Regulation agendas.<sup>91</sup> On the other hand, the transnational financial market crisis has created pressure for more governmental regulation.

In some areas, such as the regulation of money laundering and controls imposed on alleged terrorists, financial regulation is used as a tool of criminal or security law. Here, we see a different relationship between the government and non-governmental entities, as financial firms are enrolled as gatekeepers and monitors in relation to the activities of their customers. Participating in law enforcement is part of the price of the financial firm's license to do business.

In many ways, therefore, governmental authorities and non-governmental participants in the financial markets negotiate their respective roles in the control of financial activity. And the results of such negotiations vary in different places and at different times, and even with respect to different types of activity.....

Formal financial regulation is constructed in two modes: the political and the technocratic. Legislatures may focus on financial regulation as part of a program of restructuring and updating regulation more generally, or they may legislate with respect to the financial markets as a result of scandals and crises. However, much of the time rules of financial regulation are developed by means of administrative rule-making, a technocratic process where the power to make detailed rules is delegated to bodies with expertise in particular areas. Administrative agencies are not immune to politics, as they are subject to political control: legislatures set the constraints within which they operate, and politicians appoint the people who run the agencies. The funding arrangements for agencies may be designed to give them more or less freedom from political control.<sup>92</sup>

Many areas of financial regulation involve combinations of issues which are technical (and of little obvious interest to consumers) and issues which are directly relevant to consumers. Before the financial crisis it was not obvious that consumers of financial services generally should care too much about the details of capital adequacy regulation of financial institutions. But as the crisis has unfolded it has become clear that individual consumers' ability to borrow money and the value of their retirement funds were connected in fundamental ways to issues of confidence in financial institutions and the markets. Crises clearly complicate regulatory policy-making by politicizing realms which in

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<sup>90</sup> See, e.g., Caroline Bradley, *Financial Trade Associations and Multilevel Regulation*, in Ramses Wessel, Andreas Follesdal & Jan Wouters eds., *MULTILEVEL REGULATION AND THE EU: THE INTERPLAY BETWEEN GLOBAL, EUROPEAN AND NATIONAL NORMATIVE PROCESSES* (2008).

<sup>91</sup> See, e.g., Financial Services Authority, *Better Regulation Action Plan*, London: FSA, December 2005.

<sup>92</sup> For example, whereas the OCC can fund its own operations from its revenues without depending on Congressional appropriations, the SEC depends on them.

other times belong to technocrats and those they regulate, but, even in ordinary times, a more effective, and more legitimate, regime for financial regulation might recognize the inherently political (as well as technical) characteristics of financial regulation.

At the supranational level, whether standard-setters emphasize the technical aspects of their activities or the possible impact on a range of stakeholders beyond financial firms may have a significant impact on whether stakeholders other than financial firms decide to become involved in debating appropriate standards and rules. If financial firms and their trade associations, using market protection rhetoric, successfully induce standard-setters to view their work as involving only technical standards, consumers are less likely to comment on any proposed rules and standards and, as a result, their interests are less likely to be taken into account. Domestic regulators' ability to adopt this perspective is affected by their ability (or lack of ability) to ignore the political implications of their actions. But supranational standard setters such as IOSCO and the Basel Committee are inherently more insulated from the political sphere than are most domestic financial regulators. And, to the extent that standards decisions taken at the supranational level in technocratic rather than political fora are treated as pre-empting the ability of national (and sub-national) authorities to develop rules which deviate from the supranational standards, consumer-voter-taxpayers' interests are prejudiced....

Financial regulation involves complex issues of the division of functions between different authorities. Jurisdiction to prescribe and enforce regulations is allocated horizontally between authorities in different territorial areas, and vertically between authorities at different hierarchical levels within states, and at the supranational (regional or global) levels. Within a domestic legal system the source for a rule of financial regulation may be sub-national, national, or supranational.

Financial activity and transactions are visibly transnational at the wholesale and even at the retail level. The development of the remittance market illustrates that even people who are not very wealthy may engage on a regular basis in transnational financial transactions. But although financial activity is often transnational, the rules of financial regulation, and the rules of private law which help to constitute cross-border transactions, are artefacts of domestic legal systems. Thus domestic regulators, legislatures and courts are actors in transnational financial law because of cross-border transactions. From the perspective of enforcement of financial regulation, financial regulators based in different jurisdictions increasingly work together through Memoranda of Understanding (MOUs), through transnational standard-setting organizations, and in the context of supervision and enforcement. Financial firms and their trade associations often argue for harmonization of regulation in order to reduce disparities in regulation and the concomitant compliance costs or competitive inequalities.<sup>93</sup>

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<sup>93</sup> See, e.g., Italian Banking Association, response to CEBS' draft of high-level principles on Remuneration Policies (Apr.6, 2009) at [http://www.c-eps.org/getdoc/5b3cfde0-3d16-41c6-a632-ba7dc444414e/CP23\\_Italian-Banking-System.aspx](http://www.c-eps.org/getdoc/5b3cfde0-3d16-41c6-a632-ba7dc444414e/CP23_Italian-Banking-System.aspx) ("any initiative at EU level should preferably take into account progress at the international level. Indeed

The rate and volume of harmonization of financial regulation continue to increase thanks to multiple initiatives and to the recent financial crisis. Major international efforts include the work of IOSCO, the Basle Committee on Banking Supervision, and the IAIS to develop harmonized principles of financial regulation and the EU's effort to achieve a single market in financial services.<sup>94</sup> Although the EU's rules often leave very little discretion as to implementation to EU Member States, as a practical matter, as states act to implement supranational standards at the domestic level, they usually have a significant amount of discretion to adapt the standards to local conditions. Often supranational standards are drafted as very general (or "high-level") principles leaving significant scope for the exercise of discretion in implementation. Where such discretion exists, financial firms and their trade associations have double opportunities for lobbying to affect the rules which are adopted: they can lobby at the supranational level when the standards are agreed and again at the national level when the standards are transformed into domestic law. Financial firms and trade associations are in a better position than other stakeholders to influence regulatory outcomes because they have superior financial and other resources.

Within a federal or federal-type system, the foundational documents will set principles for the allocation of jurisdiction to make rules about various matters. Although the interpretation of these documents by courts and legislators may be fluid and involve political assessments and may change over time, there is an underlying set of agreements about the allocation of jurisdiction. The transnational system for the regulation of financial activity does not (yet) involve such foundational documents or even agreements. Governmental authorities in different jurisdictions work together in groups with varying memberships to establish standards which have a greater coercive impact on some states than on others. Whereas IOSCO has 109 ordinary members, the Basle Committee has 20.<sup>95</sup> But while the standards developed by IOSCO and the Basle Committee are formally not binding, the IMF encourages states to implement the standards (including states which are not able to participate directly in developing the standards) through its Standards and Codes initiative.

The processes for developing supranational standards of financial regulation are not inclusive, and tend to privilege the wealthiest countries. Although the Basle Committee's recent expansion of its membership shows some sensitivity to this issue, it is still a very select group. Supranational standard setters have responded to critiques of their legitimacy by developing more formal processes, by

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the Banking Industry operates in a global environment and as such there is a need for a coordinated response from regulators. Any initiatives which only impact banks headquartered in Europe could put those firms at a competitive disadvantage.")

<sup>94</sup> See, e.g., EU Commission, *Financial Services: Implementing the Framework for Financial Markets: Action Plan*, COM (1999) 232, May 11, 1999.

<sup>95</sup> The Basle Committee expanded its membership in March 2009 including Australia, Brazil, China, India, Korea, Mexico and Russia. Basle Committee, *Expansion of Membership Announced by the Basle Committee* (Mar. 13, 2009) available at <http://www.bis.org/press/p090313.htm> .

consulting on proposed standards, and even by establishing consultation policies.<sup>96</sup> However, despite these developments, there are still some very visible differences between consultations carried out by supranational bodies and those carried out by domestic regulators (or even by EU institutions).<sup>97</sup> Although the supranational standard setters may voluntarily undertake to comply with what they understand to be best practices with respect to consultation, their actions are not subject to any kind of judicial review at the supranational level.<sup>98</sup>

Consultation at the supranational level may be more or less meaningful. The Basel Committee has published documents which are described as consultation documents but which do not explicitly invite comments.<sup>99</sup> The documents may not even provide a name or an address of a person who is willing to receive comments. When the Basle Committee publishes final versions of documents based on prior consultative documents it may not acknowledge comments or explain why the final version of the document deviates from the consultation version.<sup>100</sup>

Defects in the processes for developing supranational standards matter because financial trade associations seek to invoke harmonization rhetoric at the national level when states are implementing supranational standards, arguing that domestic regulators should not impose more restrictive rules than those provided for in the standards or by other domestic regulators which are implementing them. In the EU, for example, financial firms have argued that the UK authorities should not “gold-plate” measures which implement EU directives.<sup>101</sup> Financial firms and their trade associations use harmonization rhetoric to suggest to domestic regulators that they should regard themselves as pre-empted by supranational standards, or even by foreign rules on the basis that

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<sup>96</sup> See, e.g., IOSCO, Executive Committee, *IOSCO Consultation Policy And Procedure*, IOSCO: Madrid, April 2005.

<sup>97</sup> The EU still has a noticeable democratic deficit but its processes for consultation are formalized, and subject to judicial review (although individuals may find it difficult to establish standing to challenge EU acts in the CFI).

<sup>98</sup> For example, even where people are designated as terrorists for the purposes of sanctions, including restriction of access to bank accounts, they may not have any right to challenge the designation at the supranational level. See, e.g., Simon Chesterman, *The Spy Who Came in from the Cold War: Intelligence and International Law*, 27 MICH. J. INT'L L. 1071 (2006).

<sup>99</sup> See, e.g., Basel Committee on Banking Supervision, Consultative Document, Supervisory Guidance for Assessing Banks' Financial Instrument Fair Value Practices (Nov. 2008) available at <http://www.bis.org/publ/bcbs145.pdf> .

<sup>100</sup> See, e.g., Basel Committee on Banking Supervision, Supervisory Guidance for Assessing Banks' Financial Instrument Fair Value Practices (Apr. 2009) available at <http://www.bis.org/publ/bcbs153.pdf> .

<sup>101</sup> See, e.g., FSA, *supra* note 91. The terminology of gold-plating combines market protection and harmonization rhetoric.

imposing stricter standards on firms they regulate will put those firms at an unfair competitive disadvantage in the transnational markets....

This paper has outlined three different sets of spheres in financial regulation which intersect with each other in complex and often opaque ways in the development of domestic financial regulation. Domestic regulation is already affected by the transnational interactions of governmental and non-governmental actors in fora with limited accountability to consumer-voters. And financial firms and their trade associations have been able to argue quite effectively that governmental authorities, in exercising regulatory authority domestically, should not impose more onerous rules than those which apply in other jurisdictions. The importance of and the intersections between these different spheres are not readily apparent to many of those who are affected by the rules and standards they develop.

As governments emphasize the development of standards of financial regulation at the supranational level, and particularly if those standards are more specific than they have been, and if the IMF exerts greater pressure on countries to implement standards, it becomes increasingly important to develop a supranational administrative law, rather than relying on self-regulation by the standard-setters.

#### **4.0 BEGINNING TO THINK ABOUT FINANCIAL INSTRUMENTS AND RISK**

##### **Derivatives transactions: excerpt from Chicago Mercantile Exchange Holdings, Inc. (CME), Prospectus for Sale of Class A Common Stock, (Dec. 6, 2002)<sup>102</sup>**

This excerpt describes the CME's business in 2002. Think about what it tells us about different financial instruments and how they may be traded. In addition, the excerpt describes some ways in which the financial markets and the regulation of the markets changed in recent years.

A futures contract is a derivatives product that provides the means for hedging, speculation and asset allocation and is used in nearly all sectors of the global economy. Those who trade futures essentially trade contracts to buy or sell an underlying commodity or financial instrument at a specific date in the future—usually within a few months or less. Futures contracts are generally traded through a centralized auction or computerized matching process, with all bids and offers on each contract made public. Through this process, a prevailing market price is reached for each contract, based primarily on the laws of supply and demand. Futures markets are rarely used to actually buy or sell the

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<sup>102</sup> At pp 65-68. The document is *available at*  
[http://www.sec.gov/Archives/edgar/data/1156375/000104746902006277/a2095862zex-99\\_1.htm](http://www.sec.gov/Archives/edgar/data/1156375/000104746902006277/a2095862zex-99_1.htm)



physical commodity or financial instrument being traded. Rather, they are used for price estimation, risk management and, for some people, investment and profit.

Dating back to the 1800s, futures initially were developed to help agricultural producers and commercial users manage the price risks they faced as a result of the various factors that affect the supply of, and demand for, crops. The futures industry still serves those markets, but has broadened beyond its agricultural origins. Today, for example, futures serve as risk management tools related to interest rates, government and other securities, stock indexes, foreign exchange and non-agricultural as well as agricultural commodities. The customer base includes professional traders, financial institutions, institutional and individual investors, as well as major corporations, manufacturers, producers, supranational entities and governments.

Notwithstanding the rapid growth and diversification of futures markets, their primary purpose remains the same—to provide an efficient mechanism for the management of price risks. Futures markets attract two kinds of market participants: hedgers, or those who seek to minimize and manage price risk, and speculators, or those who are willing to take on risk in the hope of making a profit. By buying and selling futures contracts, hedgers seek to protect themselves from adverse price changes. For example, a producer hedger wants to transfer the risk that prices will decline by the time a sale is made. By contrast, a consumer hedger wants to transfer the risk that prices will increase before a purchase is made. Speculators buy when they anticipate rising prices and sell when they anticipate declining prices. The interaction of hedgers and speculators helps to provide active, liquid and competitive markets. Other market participants utilize futures as a method of asset allocation and a means to achieve greater diversification and a potentially higher overall rate of return on their investments. These market participants attempt to assure that at least a portion of their investment portfolio is allocated to an asset class that has the potential to perform well when other portions of the portfolio are underperforming.

A futures contract is different from a share of stock, or equity, that is traded on a stock exchange. A share of stock represents an ownership interest in a corporation. A futures contract does not itself represent a direct interest in an underlying commodity or financial instrument. Rather, it is an agreement between a buyer and a seller to consummate a transaction in that commodity or financial instrument at a predetermined time in the future at a price agreed on today. One of the main attractions of futures is the leverage they provide. With relatively little initial outlay, usually just a small percentage of the contract's value, buyers and sellers are able to participate in the price movement of the full contract. As a result, the leverage can lead to substantial returns on the original investment. However, it can also lead to substantial losses. The risks associated with futures can be significant.

#### Industry Growth

According to the Futures Industry Association, the total number of futures contracts traded worldwide on reporting futures exchanges grew from approximately 475 million in 1990 to approximately 1.8 billion in 2001, representing a compound annual growth rate of approximately 13%. In the United States, the total number of futures contracts traded on futures exchanges increased from

approximately 277 million in 1990 to approximately 629 million in 2001. In Europe, the total number of futures contracts traded on futures exchanges grew from approximately 76 million in 1990 to approximately 778 million in 2001, and in Asia this number grew from 109 million in 1990 to 241 million in 2001.

The substantial recent growth in global futures trading volume is attributable to a number of factors. Increasing awareness of the importance of risk management has significantly expanded the demand for risk management tools in all economic sectors. Greater price volatility in key market sectors, such as in the fixed-income sector, has increased the need for these tools. Greater access to futures markets through technological innovation and the relaxation of regulatory barriers has also expanded the market reach of futures exchanges and the customer base for these products. Growing awareness of the opportunities to obtain or hedge market exposure through the use of futures contracts at a lower cost than the cost of obtaining or hedging comparable market exposure by purchasing or selling the underlying financial instrument or commodity has also contributed to increased customer interest in the use of futures contracts.

At year-end 2001, there were 52 futures exchanges located in 27 countries...

#### Methods of Trading

Trading in futures products at futures exchanges has traditionally occurred primarily on physical trading floors in arenas called "pits" through an auction process known as "open outcry". Open outcry trading is face-to-face trading, with each trader serving as his or her own auctioneer. The traders stand in the pit and make bids and offers to one another, via shouting or flashed hand signals, to buy and sell contracts. Only members owning or leasing a seat on the exchange may trade in the pit, and orders from individual and institutional traders are sent to these members on the trading floor, usually through a broker. The rules of many exchanges also permit block trading, which involves the private negotiation of large purchases and sales away from the trading floor, but which are settled and cleared through the exchange's clearing facilities. Futures exchanges also offer privately negotiated exchange-for-physical, or EFP, transactions and exchange basis facility, or EBF, transactions. An EFP transaction is a privately negotiated and simultaneous exchange of a futures position for a corresponding cash position, outside of the public auction market, in the context of a non-interest rate contract. An EBF is essentially an EFP trade that is transacted in the context of interest rate contracts. EFPs and EBFs are also sometimes referred to as "cash for futures transactions."

In order to expand access to their markets, most futures exchanges, either exclusively or in combination with open outcry trading facilities, provide electronic trading platforms that allow subscribing customers to obtain real-time information about bid and ask prices and trading volume and enter orders directly into the platform's centralized order book, subject to the agreement of a clearing firm to accept responsibility for clearing resulting transactions on behalf of the customer. The emergence of electronic trading has been enabled by the ongoing development of sophisticated electronic order routing and matching systems, as well as advances in communications networks and protocols...

### Liquidity of Markets

Liquidity of markets is a key component to attracting customers and ensuring the success of a market. Liquidity is important because it means a contract is easy to buy or sell quickly with minimal price disturbance. Liquidity is a function of the number of participants making a market or otherwise trading in a contract, the size, or notional value, of the positions participants are willing to accommodate and the prevailing spread between the levels at which bids and offers are quoted for the relevant contract. As a result, the volume of contracts or transactions executed on an exchange is a widely recognized indicator of liquidity on the exchange. Volume is stated in round turn trades, which represent matched buy and sell orders. In addition, the daily total of positions outstanding on an exchange, or open interest, and notional values of contracts traded are widely recognized indicators of the level of customer interest in a specific contract.

A neutral, transparent and relatively anonymous trading environment, as well as a reputation for market integrity, are critical to the establishment and maintenance of a liquid market. In addition, a successful exchange must provide cost-effective execution and have access to an advanced technology infrastructure that enables reliable and efficient trade execution as well as dependable clearing and settlement capabilities.

### Clearing and Settlement

Transactions executed on futures exchanges are settled through an entity called a clearing house that acts as a central counterparty to the clearing firm on each side of the transaction. When a futures transaction has been executed in the pit or on an electronic platform and matched, the clearing house facilitates the consummation of the transaction by substituting itself as the counterparty to both the clearing firm that is or represents the buyer and the clearing firm that is or represents the seller in the transaction. By interposing itself between two transacting parties, a clearing house guarantees the contractual obligations of the transaction. A clearing house also can provide clearing services for transactions that occur outside the pit or electronic platform, such as block trades, EFPs and EBFs.

The measures used to evaluate the strength and efficiency of a clearing house include the number of transactions that are processed per day, the amount of settlement payments that are handled per day and the amount of collateral deposits managed by the clearing house...

### Trends in the Industry

Globalization, deregulation and recent advances in technology are changing the way both the futures and broader commodities and financial exchange markets operate.

Globalization. In recent years, the world's financial markets, as well as the exchanges and marketplaces that serve them, have experienced an accelerating pace of globalization. The emphasis on greater geographic diversification of investments, investment opportunities in emerging markets and expanded cross-border commercial activities are leading to increasing levels of cross-border trading and capital movements. In response to these trends, financial exchanges within particular geographic regions, notably in Europe, are both expanding access to their markets across borders

and consolidating.

**Deregulation.** Deregulation of the financial services industry in the United States, Europe and Asia has increased customer access to products and markets, reduced regulatory barriers to product innovation and encouraged consolidation.

- **United States.** Many regulatory barriers to product development were largely repealed by the enactment of the Commodity Futures Modernization Act in the United States. The adoption of the Commodity Futures Modernization Act creates a more flexible regulatory framework for exchanges, clearing houses and other financial institutions. Among other developments, the Commodity Futures Modernization Act authorized the trading of new products, such as futures contracts on individual stocks and narrow-based stock indexes, which were prohibited under prior law. The Commodity Futures Modernization Act also enabled regulated exchanges to self-certify new contracts and rules, without the delays occasioned by regulatory review and approval, permitting quicker product launch and modification.

- **Europe and Asia.** We believe deregulation and competition will continue to pressure European exchanges to consolidate across borders to gain operating efficiencies necessary to compete for customers and intermediaries. We also believe there will be continued efforts in Europe and Asia to consolidate cash markets (or markets that directly trade financial instruments, such as securities, or commodities on a current or forward basis) and derivatives markets on single exchange platforms. Singapore Derivatives Exchange, the Tokyo Stock Exchange, Deutsche Börse Group, which owns a controlling interest in Eurex, and Euronext N.V. are major securities exchanges in addition to being futures exchanges, highlighting the growing convergence between cash and derivatives markets. Euronext N.V., which resulted from the merger of the Amsterdam Exchanges N.V., Paris Bourse SBF SA and Societe de la Bourse de Valeurs Mobilieres de Bruxelles S.A. (the Brussels Exchange), has recently acquired a controlling interest in LIFFE and announced plans to integrate their derivatives markets.

**Technological Advances.** Technological advances have led both to the decentralization of exchanges and the introduction of alternative trading systems, or ATs.

- **Decentralization.** Exchanges are no longer required to operate in specific geographic locations, and customers no longer need to act through local financial services intermediaries in some markets. Market participants around the world are now able to trade certain products nearly 24 hours a day through electronic platforms.

- **ATs.** Advances in electronic trading technology have also led to the emergence of ATs. These systems bring together the orders of buyers and sellers of financial instruments and have the capacity both to route orders to exchanges as well as to internalize customer order flow within their own order book. ATs have not yet emerged, however, in the U.S. futures markets, although a number of successful electronic trading systems offering financial derivatives that are economically similar to futures contracts operate today, particularly in the foreign exchange and fixed-income markets. It is not yet clear how these trading systems will continue to evolve in and outside the United States.

In addition to shifting surplus funds to productive uses, financial markets also enable the transfer of risks (at a price) from those who want to avoid them to those who are willing to bear them. Householders take out insurance policies to protect their investment in their homes. Growers of coffee may protect themselves against a fall in the market price of coffee by agreeing to sell their crop at a price fixed in advance. But the use of futures contracts involves costs:

... the financial requirements for participation in futures trading, such as margin requirements and broker fees, may in fact deter some producers from using these markets. However, these requirements appear unavoidable. Either they are needed to ensure the financial integrity of the marketplace and that traders meet the financial obligations associated with their positions, or they are not subject to control by the exchanges or the Commission....

There are several explanations for the relatively low level of direct producer participation in agricultural futures and option markets. A commonly expressed view is that low producer participation is a consequence of a lack of understanding concerning the economic purposes and functioning of the markets. However, other considerations appear to be equally important in explaining producers' reluctance to use these markets. Specifically, the cost and the availability of substitute risk-shifting instruments, governmental programs, and business practices that are beyond the control of the exchanges and the Commission also appear to be significant factors. Nevertheless, the exchanges have an incentive to encourage participation in their markets, which they accomplish through careful contract design, market surveillance and rule enforcement, and extensive education and information dissemination programs. The Commission facilitates commercial use of the markets through vigorous enforcement of the Act and a flexible regulatory scheme that encourages exchange innovation to design contracts that meet the risk management needs of potential commercial users. The Commission operates an extensive market surveillance program that actively monitors the markets on a daily basis to detect attempts to manipulate prices. It also reviews new contracts and amendments to existing contracts to assure that the contract markets are not readily susceptible to manipulation, and it regularly monitors the exchanges' compliance with the Act's requirements to deter manipulation and to prevent trading abuses. The Commission also operates an active law enforcement program designed to prosecute fraud and oversees an industry registration program for commodity professionals that seeks to police their activities.<sup>103</sup>

Financial instruments may be used to hedge business risks. For example, firms which have income in one currency and liabilities in another currency may enter into contracts to

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<sup>103</sup> CFTC, SPECIAL PROCEDURES TO ENCOURAGE AND FACILITATE BONA FIDE HEDGING BY AGRICULTURAL PRODUCERS, 5 (Dec. 2001) *available at* <http://www.cftc.gov/files/dea/deabonafidehedgingreport.pdf>

swap their obligation to pay into the currency of their income (this is a currency swap). People may buy options to acquire securities in the future (giving them rights to buy the securities at a particular price at a particular time in the future, or futures, which require them to buy or sell the security at a fixed price at a particular time in the future. These are examples of transactions in derivatives. Derivatives may be used for hedging or speculation, and derivatives transactions are regulated,<sup>104</sup> although some derivatives transactions may be subject to more regulation than others. Swap transactions tend to look more like individually negotiated contracts than exchange traded derivative products and as a result have historically been subject to less regulation,<sup>105</sup> although this has changed since the global financial crisis. In the US, the Dodd-Frank Act introduced a new system for regulating swaps, including requirements that certain swaps be cleared through clearing agencies, and the CFTC and SEC are in the process of developing rules for these new markets.<sup>106</sup>

In a derivatives transaction involving two parties there may be two speculators or two hedgers (each party may take a different view of the risks, or may have different characteristics which mean that they need to hedge against different eventualities) or one speculator and one hedger. In a currency swap, for example, X may have obligations to make payments denominated in US\$ (X may have borrowed money in a US\$ loan which may have offered the most favorable interest rates at the time X borrowed the money) but have most of its income in euros. In these circumstances X might be worried about the risk that US\$ will increase in value compared to euros and want to enter into a swap transaction to hedge this risk. The cost of entering into the swap plus the US\$ interest on the loan might be less than the cost of taking out a euro denominated loan. The other party to this swap could be a firm with assets in US\$ and liabilities in euros (the reverse of X's position) and might want to hedge the risk that euros would increase in value compared to US\$. But the other party could also be a speculator. The protection buyer under a credit default swap may be an entity that is exposed to credit risk with respect to a particular reference entity (such as a bank that has lent money to the reference entity) but it may not in fact have any such

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<sup>104</sup> In the US, the Commodities Futures Trading Commission (CFTC) regulates derivatives activities under the Commodity Exchange Act of 1970 and the Commodities Futures Modernization Act of 2000CFTC . See generally <http://www.cftc.gov> . The CFTC and the Securities Exchange Commission share the regulation of security futures products (futures on individual securities).

<sup>105</sup> Banks which enter into swap contracts need to have regulatory capital in respect of risks associated with these contracts.

<sup>106</sup> See <http://www.cftc.gov/LawRegulation/DoddFrankAct/Dodd-FrankProposedRules/index.htm> ; <http://www.sec.gov/news/press/2010/2010-243.htm> .

exposure and may merely be speculating on the creditworthiness of the reference entity.

The derivatives markets illustrate the tendency of the financial markets to become increasingly complex over time. Financial firms are developing new financial products and transactions all the time and regulators are often concerned that the firms which are involved in these products and transactions may not fully understand how the products/transactions work and the risks which they involve. Regulators began to be concerned about the risks associated with credit derivatives before the current market turmoil, and recent events have exacerbated this concern. Credit derivatives transactions are supposed to transfer credit risk. Credit risk is the risk that a party to a financial transaction (such as a loan) will not be able to meet its obligations under the transaction. This would cause a loss to the other party or parties to the transaction. In the spring of 2005, the BIS warned that if the parties to credit derivatives transactions did not understand the risks associated with those transactions, such transactions might threaten financial stability.<sup>107</sup> Credit derivatives can have the effect of transferring risk away from regulated entities such as banks to less regulated entities. Regulators were concerned about how to deal with newer and complex financial products such as credit derivatives in assessing risk before the crisis. For example, at the end of 2005 the UK's Pension Protection Fund, which is responsible for pricing the risk that defined benefit pension funds in the UK are underfunded, and which imposes levies which are used to compensate pension fund members who incur losses as a result of underfunding, suggested that it would not give pension funds credit for using credit default swaps<sup>108</sup> for the 2006/7 levy. The Fund does give pension funds credit for guarantees, security over cash, real property and securities and letters of credit.<sup>109</sup> The Fund stated :

The Board has also considered the inclusion of credit default swaps, but has decided not to recognise

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<sup>107</sup> See, e.g., Basle Committee on Banking Supervision, The Joint Forum, *Credit Risk Transfer*, (March 2005) available at <http://www.bis.org/publ/joint13.pdf>

<sup>108</sup> A credit default swap is a type of credit derivative. A protection buyer pays a protection seller for the swap. In the event of a credit event (what constitutes a credit event is defined in the documentation for the swap) the protection seller will make a payment to the protection buyer. In theory the credit default swap transfers the costs associated with a default away from the entity that originally bore the credit default risk (for example a bank lender to a corporate borrower) to the protection seller. But if the protection seller becomes insolvent the credit risk protection may disappear. Credit default swaps led to the rescue of AIG. See above at page [19](#).

<sup>109</sup> Pension Protection Fund, Guidance in Relation to Contingent Assets (Dec. 2009) at [http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/Contingent\\_asset\\_guidance\\_Dec09.pdf](http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/Contingent_asset_guidance_Dec09.pdf).

these for the 2006/7 levy year. These may be included in future levy years, if standardised documentation and procedures can be developed to reflect the specific and more complex mechanics of their operation, and if there is evidence that such products may be practically used by pension schemes. The Board will also consider the inclusion of credit insurance policies for future levy years, should evidence demonstrate that such products would become widely used.<sup>110</sup>

The International Swaps and Derivatives Association (ISDA) challenged the assertion that there were not standard forms for credit default swaps:

Standard-form documentation very much does exist for a wide range of credit derivatives, including credit default swaps (CDS). The consultation document incorrectly asserts (p19) that this is not the case. The credit derivatives market has been in existence for over 10 years, while ISDA plays a well established and widely supported role in developing and maintaining documentation for all major forms of 'over-the-counter' derivatives. Much of the well publicised growth in credit derivatives can be directly attributed to the development of standard-form documentation.<sup>111</sup>

Note that the Fund now requires not merely standardized documentation, but documentation that conforms to the forms it specifies. And, since the crisis many commentators have noted that the risk spreading that credit default swaps were supposed to achieve was in fact illusory.

ISDA describes itself as a global trade association: it has offices in New York, Washington DC, London, Brussels, Tokyo and Singapore and it comments on regulatory proposals from different authorities around the world that would affect derivatives transactions. This ISDA comment is therefore an illustration of how matters that may seem to be purely or largely domestic (the funding of UK-based pension funds) have transnational implications. International financial markets may constrain domestic policy choices.

Participants in the derivatives markets (like participants in other financial markets) may be concerned about being subjected to different regulatory requirements in the different national markets in which they operate. The CFTC and the EU agreed to co-operate in

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<sup>110</sup> Pension Protection Fund, THE PENSION PROTECTION LEVY CONSULTATION DOCUMENT, para. 2.3.27 (Dec. 2005). The Fund does provide standardized documentation for the contingent assets it does accept as reducing underfunding risk. See <http://www.pensionprotectionfund.org.uk/levy/riskreduction/Pages/ContingentAssets.aspx> .

<sup>111</sup> See <http://www.isda.org/whatsnew/pdf/PrelimResp.pdf>



relation to the regulation of derivatives.<sup>112</sup>

In May 2008 the CFTC issued a concept release on the regulation of event contracts:

Since 2005, the Commission's staff has received a substantial number of requests for guidance on the propriety of offering and trading financial agreements that may primarily function as information aggregation vehicles. These event contracts generally take the form of financial agreements linked to eventualities or measures that neither derive from, nor correlate with, market prices or broad economic or commercial measures. Event contracts have been based on a wide variety of interests including the results of presidential elections, the accomplishment of certain scientific advances, world population levels, the adoption of particular pieces of legislation, the outcome of corporate product sales, the declaration of war and the length of celebrity marriages. In response to the various requests for guidance, and to promote regulatory certainty, the Commission has commenced a comprehensive review of the Act's applicability to event contracts and markets.<sup>113</sup>

**Do you think that the distinction between hedging and speculation should be significant for financial regulation? Should regulation discourage speculation? Should regulation discourage speculation generally, or only by people who cannot properly evaluate the risks? How can we tell whether people can evaluate the risks of speculation?**

Different countries may regulate different types of financial activity in different ways. So, firms which are regulated in one country and which want to carry on business in another country may find it difficult to gain access to the second country's financial markets,<sup>114</sup> or may be subjected to different rules in the second country. Either type of rule (access restriction or requirement to follow two sets of rules) may function as a barrier to entry into the second country's market. The GATS (General Agreement on Trade in Services) aims at progressive liberalization of trade in services, including financial services among parties to the

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<sup>112</sup> See, e.g., CESR-CFTC Common Work Program to Facilitate Transatlantic Derivatives Business (Jun. 2005) available at <http://www.cftc.gov/files/opa/press05/opa-communique-24-june-final.pdf> ; CFTC, CESR Press Release, CESR Chairman Visits US CFTC Chairman and Attends Global Markets Roundtable, (Dec. 14, 2005) available at <http://www.cftc.gov/opa/press05/opa5143-05.htm> .

<sup>113</sup> CFTC, Concept Release on the Appropriate Regulatory Treatment of Event Contracts, 73 Fed. Reg. 25669 (May 7, 2008) available at <http://edocket.access.gpo.gov/2008/pdf/E8-9981.pdf> .

<sup>114</sup> This second country is commonly referred to as the "host" country.

agreement.<sup>115</sup> NAFTA also contains a Chapter on Financial Services.<sup>116</sup> Within systems for free trade in services, there is always the question whether a particular national rule is a prohibited interference with free trade, or is a legitimate means of ensuring consumer protection. For example, Paragraph 2 of the GATS Annex on Financial Services states:

2. *Domestic Regulation*

(a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement.

(b) Nothing in the Agreement shall be construed to require a Member to disclose information relating to the affairs and accounts of individual customers or any confidential or proprietary information in the possession of public entities.

**Do you think it is likely to be easy to balance the need for investor/depositor protection with the requirement to avoid barriers to free trade?**

This issue of distinguishing between legitimate and illegitimate host country rules is also an issue within the EU which is seeking to achieve a single market in financial services. In 2005, the EU Commission wrote:

The objectives of the Commission's financial services policy over the next 5 years are to:

- consolidate dynamically towards an integrated, open, inclusive, competitive, and economically efficient EU financial market;
- remove the remaining economically significant barriers so financial services can be provided and capital can circulate freely throughout the EU at the lowest possible cost – with effective levels of prudential and conduct of business regulation, resulting in high levels of financial stability, consumer benefits and consumer protection
- implement, enforce and continuously evaluate the existing legislation and to apply rigorously the better regulation agenda to future initiatives
- enhance supervisory cooperation and convergence in the EU, deepen relations with other

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<sup>115</sup> See, e.g., GATS, at [http://www.wto.org/english/docs\\_e/legal\\_e/26-gats.pdf](http://www.wto.org/english/docs_e/legal_e/26-gats.pdf)

<sup>116</sup> See, e.g., NAFTA Chapter 14, at <http://tmtm.free.fr/nafta/nafta14.htm>

global financial marketplaces and strengthen European influence globally.<sup>117</sup>

The EU seeks to integrate financial markets by removing barriers and by agreeing on harmonized rules on financial services, but the process of harmonizing the rules is a slow one. Harmonization of regulation is difficult even where the countries involved are at similar levels of economic development, and have similar cultural environments. Where culture and history diverge, harmonization is even more problematic.<sup>118</sup> We will think about regulatory harmonization in more detail later.

The promotion of free trade in financial services is one reason for promoting harmonization of financial regulation. Another is the desire of governments and regulators in developed countries to protect their financial markets from various types of threat from other countries. If countries generally had similar levels of investor protection, then they would not need to worry about protection of their own residents who decided to invest abroad. Harmonization of regulation is an alternative to extraterritorial application of rules.

Regulatory harmonization also limits the ability of firms to escape regulation by moving their activities into another jurisdiction (regulatory arbitrage). International harmonization of money laundering regulation is an example of this concern at work. In November 2002 the IMF agreed to include “the Financial Action Task Force (FATF) 40 Recommendations on an effective anti-money laundering framework, and the 8 Special Recommendations on Terrorism Financing<sup>119</sup> (FATF 40+ 8), in the list of areas and associated standards and codes that are incorporated into the operational work of the Fund”.<sup>120</sup> This means that the IMF monitors the application of these recommendations as it monitors other aspects of the countries whose affairs it reviews.

Legal harmonization is also designed to protect countries from the effects of financial crises which affect other countries. For example, a 2002 report argued that “the legal

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<sup>117</sup> See, e.g., EU Commission, WHITE PAPER: FINANCIAL SERVICES POLICY 2005-2010 (Dec. 5, 2005) available at [http://ec.europa.eu/internal\\_market/finances/docs/white\\_paper/white\\_paper\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/white_paper/white_paper_en.pdf).

<sup>118</sup> See, e.g., V Sundararajan & Luca Errico, *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead*, IMF Working Paper WP/02/192, (Nov. 2002) available at <http://www.imf.org/external/pubs/ft/wp/2002/wp02192.pdf> (describing problems of applying Western risk management principles to Islamic financial products and services).

<sup>119</sup> See above at [7](#).

<sup>120</sup> IMF Press Release, *IMF Executive Board Approves 12-Month Anti-Money Laundering Pilot Project*, No. 02/52 (Nov. 22, 2002) available at <http://www.imf.org/external/np/sec/pr/2002/pr0252.htm>. For FATF’s activities, see

uncertainty, inefficiency and potential inequity resulting from the existing legal and institutional underpinnings of insolvency may be incompatible with important objectives of public policy related to financial stability. Moreover, the risks involved may be growing as the pace of change in the financial system continues to outstrip that of the insolvency framework.”<sup>121</sup> The World Bank has established a set of Principles for Effective Insolvency and Creditor Rights Systems,<sup>122</sup> and UNCITRAL has developed a Model Law on Cross-Border Insolvency:<sup>123</sup> it remains to be seen whether the Model Law, as implemented, deals effectively with the insolvencies resulting from the financial crisis.

As we have already seen, crises in developing markets during the 1990s led to general concern about the “International Financial Architecture”,<sup>124</sup> and to the setting up of the Financial Stability Institute,<sup>125</sup> and the Financial Stability Forum (now the Financial Stability Board). A large body of literature connects the level of development of a country’s securities markets with its economic health. It has been argued that countries with strong

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<sup>121</sup> Contact Group on the Legal and Institutional Underpinnings of the International Financial System, *Insolvency Arrangements and Contract Enforceability*, 46 (Sep. 2002) available at <http://www.bis.org/publ/gten06.pdf>. The EU has adopted a regulation on insolvency proceedings. Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings, OJ L160/1 (Jun. 30, 2000).

<sup>122</sup> See <http://siteresources.worldbank.org/GILD/Resources/FINAL-ICRPrinciples-March2009.pdf>.

<sup>123</sup> UNCITRAL Model Law on Cross-Border Insolvency, at <http://www.uncitral.org/pdf/english/texts/insolven/insolvency-e.pdf> UNCITRAL says that: “Legislation based on the UNCITRAL Model Law on Cross-Border Insolvency has been adopted in: Australia (2008), British Virgin Islands; overseas territory of the United Kingdom of Great Britain and Northern Ireland (2003), Canada (2009), Colombia (2006), Eritrea (1998), Great Britain (2006), Greece (2010), Japan (2000), Mauritius (2009), Mexico (2000), Montenegro (2002), New Zealand (2006), Poland (2003), Republic of Korea (2006), Romania (2003), Serbia (2004), Slovenia (2007), South Africa (2000), and the United States of America (2005).” See [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html)

<sup>124</sup> See, e.g., *Introduction to Reports on the International Financial Architecture - Reports of Working Groups* (Oct. 1998) available at <http://www.bis.org/publ/othp01.htm> (“The international financial crisis that began in Asia and has now spread to other continents lends urgency to efforts to strengthen the architecture of the international financial system. The importance of these efforts was first given prominence in 1995 at the Halifax summit of heads of state and government of G-7 countries, and progress since has benefited from the involvement of finance ministries and central banks from both developed and emerging market economies... In their discussions, Ministers and Governors stressed the importance of strengthening the international financial system through action in three key areas: enhancing transparency and accountability; strengthening domestic financial systems; and managing international financial crises.”)

<sup>125</sup> <http://www.bis.org/fsi/index.htm>

securities markets tend to have high levels of economic growth.<sup>126</sup> Thus it has been argued that increasing standards of regulation in less developed economies not only protects developed economies by reducing the likelihood of crises which might infect the developed economies, but also benefits less developed economies more directly.

It is worth noting that some commentators have challenged the idea that changing legal rules necessarily promotes economic development.<sup>127</sup> And some critics of harmonization have argued that legal harmonization has risks:

I am also concerned that the effort to homogenize capital rules across the world may do serious damage to certain markets in which U.S. banks – particularly national banks – have been world leaders, such as credit cards and securitizations. We have to exercise great caution that we do not, in the name of achieving international uniformity, needlessly disrupt settled banking practices and established, well-functioning markets.<sup>128</sup>

Some commentators argue that rather than emphasizing harmonization of law and regulation we should allow different countries to compete with each other in the laws and regulations they apply, because such legal and regulatory competition will produce the most efficient regulatory outcomes.

The financial crisis has produced a number of multilateral statements about the desirability of harmonization in some areas. For example:

### **Declaration of the Summit on Financial Markets and the World Economy**<sup>129</sup>

1. We, the Leaders of the Group of Twenty, held an initial meeting in Washington on November 15, 2008, amid serious challenges to the world economy and financial markets. We are determined to

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<sup>126</sup> See, e.g., Bharat N. Anand & Alexander Galetovic, *Investment Banking and Security Market Development*, IMF Working Paper, WP/01/90, July 2001, available at <http://www.imf.org/external/pubs/ft/wp/2001/wp0190.pdf>.

<sup>127</sup> See, e.g., Gordon Smith, *Taking Legal Origins Theory Seriously*, Jotwell (Jan. 7, 2011) at <http://corp.jotwell.com/taking-legal-origins-theory-seriously/>.

<sup>128</sup> John D. Hawke, Jr., (then) Comptroller of the Currency, *Basel II: A Brave New World for Financial Institutions?*, speech to the American Academy in Berlin, Dec. 15, 2003, available from <http://www.occ.treas.gov/ftp/release/2003-99a.pdf>

<sup>129</sup> (Nov. 15, 2008 ) available at [http://www.info-france-usa.org/IMG/pdf\\_Declaration\\_of\\_the\\_Summit\\_on\\_Financial\\_Markets.pdf](http://www.info-france-usa.org/IMG/pdf_Declaration_of_the_Summit_on_Financial_Markets.pdf).

enhance our cooperation and work together to restore global growth and achieve needed reforms in the world's financial systems.

2. Over the past months our countries have taken urgent and exceptional measures to support the global economy and stabilize financial markets. These efforts must continue. At the same time, we must lay the foundation for reform to help to ensure that a global crisis, such as this one, does not happen again. Our work will be guided by a shared belief that market principles, open trade and investment regimes, and effectively regulated financial markets foster the dynamism, innovation, and entrepreneurship that are essential for economic growth, employment, and poverty reduction.

#### Root Causes of the Current Crisis

3. During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.

4. Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruption.

#### Actions Taken and to Be Taken

5. We have taken strong and significant actions to date to stimulate our economies, provide liquidity, strengthen the capital of financial institutions, protect savings and deposits, address regulatory deficiencies, unfreeze credit markets, and are working to ensure that international financial institutions (IFIs) can provide critical support for the global economy.

6. But more needs to be done to stabilize financial markets and support economic growth. Economic momentum is slowing substantially in major economies and the global outlook has weakened. Many emerging market economies, which helped sustain the world economy this decade, are still experiencing good growth but increasingly are being adversely impacted by the worldwide slowdown.

7. Against this background of deteriorating economic conditions worldwide, we agreed that a broader policy response is needed, based on closer macroeconomic cooperation, to restore growth, avoid negative spillovers and support emerging market economies and developing countries. As immediate steps to achieve these objectives, as well as to address longer-term challenges, we will:

; Continue our vigorous efforts and take whatever further actions are necessary to stabilize the financial system.

; Recognize the importance of monetary policy support, as deemed appropriate to domestic

conditions.

- ; Use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability.

- ; Help emerging and developing economies gain access to finance in current difficult financial conditions, including through liquidity facilities and program support. We stress the International Monetary Fund's (IMF) important role in crisis response, welcome its new short-term liquidity facility, and urge the ongoing review of its instruments and facilities to ensure flexibility.

- ; Encourage the World Bank and other multilateral development banks (MDBs) to use their full capacity in support of their development agenda, and we welcome the recent introduction of new facilities by the World Bank in the areas of infrastructure and trade finance.

- ; Ensure that the IMF, World Bank and other MDBs have sufficient resources to continue playing their role in overcoming the crisis.

#### Common Principles for Reform of Financial Markets

8. In addition to the actions taken above, we will implement reforms that will strengthen financial markets and regulatory regimes so as to avoid future crises. Regulation is first and foremost the responsibility of national regulators who constitute the first line of defense against market instability. However, our financial markets are global in scope, therefore, intensified international cooperation among regulators and strengthening of international standards, where necessary, and their consistent implementation is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability. Regulators must ensure that their actions support market discipline, avoid potentially adverse impacts on other countries, including regulatory arbitrage, and support competition, dynamism and innovation in the marketplace. Financial institutions must also bear their responsibility for the turmoil and should do their part to overcome it including by recognizing losses, improving disclosure and strengthening their governance and risk management practices.

9. We commit to implementing policies consistent with the following common principles for reform.

- ; Strengthening Transparency and Accountability: We will strengthen financial market transparency, including by enhancing required disclosure on complex financial products and ensuring complete and accurate disclosure by firms of their financial conditions. Incentives should be aligned to avoid excessive risk-taking.

- ; Enhancing Sound Regulation: We pledge to strengthen our regulatory regimes, prudential oversight, and risk management, and ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances. We will exercise strong oversight over credit rating agencies, consistent with the agreed and strengthened international code of conduct. We will also make regulatory regimes more effective over the economic cycle, while ensuring that regulation is efficient, does not stifle innovation, and encourages expanded trade in financial products and services. We commit to transparent assessments of our national regulatory systems.

; Promoting Integrity in Financial Markets: We commit to protect the integrity of the world's financial markets by bolstering investor and consumer protection, avoiding conflicts of interest, preventing illegal market manipulation, fraudulent activities and abuse, and protecting against illicit finance risks arising from non-cooperative jurisdictions. We will also promote information sharing, including with respect to jurisdictions that have yet to commit to international standards with respect to bank secrecy and transparency.

; Reinforcing International Cooperation: We call upon our national and regional regulators to formulate their regulations and other measures in a consistent manner. Regulators should enhance their coordination and cooperation across all segments of financial markets, including with respect to cross-border capital flows. Regulators and other relevant authorities as a matter of priority should strengthen cooperation on crisis prevention, management, and resolution.

; Reforming International Financial Institutions: We are committed to advancing the reform of the Bretton Woods Institutions so that they can more adequately reflect changing economic weights in the world economy in order to increase their legitimacy and effectiveness. In this respect, emerging and developing economies, including the poorest countries, should have greater voice and representation. The Financial Stability Forum (FSF) must expand urgently to a broader membership of emerging economies, and other major standard setting bodies should promptly review their membership. The IMF, in collaboration with the expanded FSF and other bodies, should work to better identify vulnerabilities, anticipate potential stresses, and act swiftly to play a key role in crisis response.

#### Tasking of Ministers and Experts

10. We are committed to taking rapid action to implement these principles. We instruct our Finance Ministers, as coordinated by their 2009 G-20 leadership (Brazil, UK, Republic of Korea), to initiate processes and a timeline to do so. An initial list of specific measures is set forth in the attached Action Plan, including high priority actions to be completed prior to March 31, 2009.

In consultation with other economies and existing bodies, drawing upon the recommendations of such eminent independent experts as they may appoint, we request our Finance Ministers to formulate additional recommendations, including in the following specific areas:

- \* Mitigating against pro-cyclicality in regulatory policy;
- \* Reviewing and aligning global accounting standards, particularly for complex securities in times of stress;
- \* Strengthening the resilience and transparency of credit derivatives markets and reducing their systemic risks, including by improving the infrastructure of over-the-counter markets;
- \* Reviewing compensation practices as they relate to incentives for risk taking and innovation\*
- \* Reviewing the mandates, governance, and resource requirements of the IFIs\* and
- \* Defining the scope of systemically important institutions and determining their appropriate regulation or oversight.

11. In view of the role of the G-20 in financial systems reform, we will meet again by April 30, 2009, to



review the implementation of the principles and decisions agreed today.

#### Commitment to an Open Global Economy

12. We recognize that these reforms will only be successful if grounded in a commitment to free market principles, including the rule of law, respect for private property, open trade and investment, competitive markets, and efficient, effectively regulated financial systems. These principles are essential to economic growth and prosperity and have lifted millions out of poverty, and have significantly raised the global standard of living. Recognizing the necessity to improve financial sector regulation, we must avoid over-regulation that would hamper economic growth and exacerbate the contraction of capital flows, including to developing countries.

13. We underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty. In this regard, within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures to stimulate exports. Further, we shall strive to reach agreement this year on modalities that leads to a successful conclusion to the WTO's Doha Development Agenda with an ambitious and balanced outcome. We instruct our Trade Ministers to achieve this objective and stand ready to assist directly, as necessary. We also agree that our countries have the largest stake in the global trading system and therefore each must make the positive contributions necessary to achieve such an outcome.

14. We are mindful of the impact of the current crisis on developing countries, particularly the most vulnerable. We reaffirm the importance of the Millennium Development Goals, the development assistance commitments we have made, and urge both developed and emerging economies to undertake commitments consistent with their capacities and roles in the global economy. In this regard, we reaffirm the development principles agreed at the 2002 United Nations Conference on Financing for Development in Monterrey, Mexico, which emphasized country ownership and mobilizing all sources of financing for development.

15. We remain committed to addressing other critical challenges such as energy security and climate change, food security, the rule of law, and the fight against terrorism, poverty and disease.

16. As we move forward, we are confident that through continued partnership, cooperation, and multilateralism, we will overcome the challenges before us and restore stability and prosperity to the world economy.

#### Action Plan to Implement Principles for Reform

This Action Plan sets forth a comprehensive work plan to implement the five agreed principles for reform. Our finance ministers will work to ensure that the taskings set forth in this Action Plan are fully and vigorously implemented. They are responsible for the development and implementation of these recommendations drawing on the ongoing work of relevant bodies, including the International Monetary Fund (IMF), an expanded Financial Stability Forum (FSF), and standard setting bodies.

### Strengthening Transparency and Accountability

Immediate Actions by March 31, 2009

- \* The key global accounting standards bodies should work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products, especially during times of stress.
- \* Accounting standard setters should significantly advance their work to address weaknesses in accounting and disclosure standards for off-balance sheet vehicles.
- \* Regulators and accounting standard setters should enhance the required disclosure of complex financial instruments by firms to market participants.
- \* With a view toward promoting financial stability, the governance of the international accounting standard setting body should be further enhanced, including by undertaking a review of its membership, in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities.
- \* Private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded FSF, and other relevant bodies.

### Medium-term actions

- \* The key global accounting standards bodies should work intensively toward the objective of creating a single high-quality global standard.
- \* Regulators, supervisors, and accounting standard setters, as appropriate, should work with each other and the private sector on an ongoing basis to ensure consistent application and enforcement of high-quality accounting standards.
- \* Financial institutions should provide enhanced risk disclosures in their reporting and disclose all losses on an ongoing basis, consistent with international best practice, as appropriate. Regulators should work to ensure that a financial institution's financial statements include a complete, accurate, and timely picture of the firm's activities (including off-balance sheet activities) and are reported on a consistent and regular basis.

### Enhancing Sound Regulation

#### Regulatory Regimes

Immediate Actions by March 31, 2009

- \* The IMF, expanded FSF, and other regulators and bodies should develop recommendations to mitigate pro-cyclicality, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends.

### Medium-term actions

- \* To the extent countries or regions have not already done so, each country or region pledges to

review and report on the structure and principles of its regulatory system to ensure it is compatible with a modern and increasingly globalized financial system. To this end, all G-20 members commit to undertake a Financial Sector Assessment Program (FSAP) report and support the transparent assessments of countries' national regulatory systems.

\* The appropriate bodies should review the differentiated nature of regulation in the banking, securities, and insurance sectors and provide a report outlining the issue and making recommendations on needed improvements. A review of the scope of financial regulation, with a special emphasis on institutions, instruments, and markets that are currently unregulated, along with ensuring that all systemically-important institutions are appropriately regulated, should also be undertaken.

\* National and regional authorities should review resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly wind-down of large complex cross-border financial institutions.

\* Definitions of capital should be harmonized in order to achieve consistent measures of capital and capital adequacy.

#### Prudential Oversight

##### Immediate Actions by March 31, 2009

\* Regulators should take steps to ensure that credit rating agencies meet the highest standards of the international organization of securities regulators and that they avoid conflicts of interest, provide greater disclosure to investors and to issuers, and differentiate ratings for complex products. This will help ensure that credit rating agencies have the right incentives and appropriate oversight to enable them to perform their important role in providing unbiased information and assessments to markets.

\* The international organization of securities regulators should review credit rating agencies' adoption of the standards and mechanisms for monitoring compliance.

\* Authorities should ensure that financial institutions maintain adequate capital in amounts necessary to sustain confidence. International standard setters should set out strengthened capital requirements for banks' structured credit and securitization activities.

\* Supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps (CDS) in some countries, should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes.

##### Medium-term actions

\* Credit Ratings Agencies that provide public ratings should be registered.

\* Supervisors and central banks should develop robust and internationally consistent approaches for liquidity supervision of, and central bank liquidity operations for, cross-border banks.

### Risk Management

#### Immediate Actions by March 31, 2009

- \* Regulators should develop enhanced guidance to strengthen banks' risk management practices, in line with international best practices, and should encourage financial firms to reexamine their internal controls and implement strengthened policies for sound risk management.
- \* Regulators should develop and implement procedures to ensure that financial firms implement policies to better manage liquidity risk, including by creating strong liquidity cushions.
- \* Supervisors should ensure that financial firms develop processes that provide for timely and comprehensive measurement of risk concentrations and large counterparty risk positions across products and geographies.
- \* Firms should reassess their risk management models to guard against stress and report to supervisors on their efforts.
- \* The Basel Committee should study the need for and help develop firms' new stress testing models, as appropriate.
- \* Financial institutions should have clear internal incentives to promote stability, and action needs to be taken, through voluntary effort or regulatory action, to avoid compensation schemes which reward excessive short-term returns or risk taking.
- \* Banks should exercise effective risk management and due diligence over structured products and securitization.

#### Medium -term actions

- \* International standard setting bodies, working with a broad range of economies and other appropriate bodies, should ensure that regulatory policy makers are aware and able to respond rapidly to evolution and innovation in financial markets and products.
- \* Authorities should monitor substantial changes in asset prices and their implications for the macroeconomy and the financial system.

### Promoting Integrity in Financial Markets

#### Immediate Actions by March 31, 2009

- \* Our national and regional authorities should work together to enhance regulatory cooperation between jurisdictions on a regional and international level.
- \* National and regional authorities should work to promote information sharing about domestic and cross-border threats to market stability and ensure that national (or regional, where applicable) legal provisions are adequate to address these threats.
- \* National and regional authorities should also review business conduct rules to protect markets and investors, especially against market manipulation and fraud and strengthen their cross-border cooperation to protect the international financial system from illicit actors. In case of misconduct, there should be an appropriate sanctions regime.

## Medium -term actions

- \* National and regional authorities should implement national and international measures that protect the global financial system from uncooperative and non-transparent jurisdictions that pose risks of illicit financial activity.
- \* The Financial Action Task Force should continue its important work against money laundering and terrorist financing, and we support the efforts of the World Bank - UN Stolen Asset Recovery (StAR) Initiative.
- \* Tax authorities, drawing upon the work of relevant bodies such as the Organization for Economic Cooperation and Development (OECD), should continue efforts to promote tax information exchange. Lack of transparency and a failure to exchange tax information should be vigorously addressed.

## Reinforcing International Cooperation

## Immediate Actions by March 31, 2009

- \* Supervisors should collaborate to establish supervisory colleges for all major cross-border financial institutions, as part of efforts to strengthen the surveillance of cross-border firms. Major global banks should meet regularly with their supervisory college for comprehensive discussions of the firm's activities and assessment of the risks it faces.
- \* Regulators should take all steps necessary to strengthen cross-border crisis management arrangements, including on cooperation and communication with each other and with appropriate authorities, and develop comprehensive contact lists and conduct simulation exercises, as appropriate.

## Medium -term actions

- \* Authorities, drawing especially on the work of regulators, should collect information on areas where convergence in regulatory practices such as accounting standards, auditing, and deposit insurance is making progress, is in need of accelerated progress, or where there may be potential for progress.
- \* Authorities should ensure that temporary measures to restore stability and confidence have minimal distortions and are unwound in a timely, well-sequenced and coordinated manner.

## Reforming International Financial Institutions

## Immediate Actions by March 31, 2009

- \* The FSF should expand to a broader membership of emerging economies.
- \* The IMF, with its focus on surveillance, and the expanded FSF, with its focus on standard setting, should strengthen their collaboration, enhancing efforts to better integrate regulatory and supervisory responses into the macro-prudential policy framework and conduct early warning exercises.
- \* The IMF, given its universal membership and core macro-financial expertise, should, in close coordination with the FSF and others, take a leading role in drawing lessons from the current crisis, consistent with its mandate.
- \* We should review the adequacy of the resources of the IMF, the World Bank Group and other

multilateral development banks and stand ready to increase them where necessary. The IFIs should also continue to review and adapt their lending instruments to adequately meet their members' needs and revise their lending role in the light of the ongoing financial crisis.

\* We should explore ways to restore emerging and developing countries' access to credit and resume private capital flows which are critical for sustainable growth and development, including ongoing infrastructure investment.

\* In cases where severe market disruptions have limited access to the necessary financing for counter-cyclical fiscal policies, multilateral development banks must ensure arrangements are in place to support, as needed, those countries with a good track record and sound policies.

#### Medium -term actions

\* We underscored that the Bretton Woods Institutions must be comprehensively reformed so that they can more adequately reflect changing economic weights in the world economy and be more responsive to future challenges. Emerging and developing economies should have greater voice and representation in these institutions.

\* The IMF should conduct vigorous and even-handed surveillance reviews of all countries, as well as giving greater attention to their financial sectors and better integrating the reviews with the joint IMF/World Bank financial sector assessment programs. On this basis, the role of the IMF in providing macro-financial policy advice would be strengthened.

\* Advanced economies, the IMF, and other international organizations should provide capacity-building programs for emerging market economies and developing countries on the formulation and the implementation of new major regulations, consistent with international standards.

#### At the beginning of 2009, the Financial Stability Board published the **FSB Framework for Strengthening Adherence to International Standards**:<sup>130</sup>

The FSB is committed to strengthening adherence to international financial standards. Financial markets are global in scope and, therefore, consistent implementation of international standards is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability.

The FSB, working through the Standing Committee on Standards Implementation, will foster a race to the top, wherein encouragement from peers motivates all countries and jurisdictions to raise their level of adherence to international financial standards. Encouragement will come in three forms. First, FSB member jurisdictions will lead by example. FSB member jurisdictions have committed to implementing international financial standards and disclosing their level of adherence.

Second, FSB member jurisdictions will undergo periodic peer reviews to evaluate their adherence to

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<sup>130</sup> At [http://www.financialstabilityboard.org/publications/r\\_100109a.pdf](http://www.financialstabilityboard.org/publications/r_100109a.pdf) .

international standards in the regulatory and supervisory area. Such evaluations will provide members with feedback from peers on the implementation and effectiveness of standards and policies.

Moreover they will encourage non-FSB member jurisdictions to undergo similar evaluations.

Third, the FSB will establish a toolbox of measures to encourage adherence to international cooperation and information exchange standards by all countries and jurisdictions. Application of these measures will be based on transparent procedures to evaluate the degree of adherence of jurisdictions to the relevant standards.

...FSB members' adherence to international standards is essential to reinforce the credibility of the FSB's efforts to strengthen adherence by all countries and jurisdictions. To lead by example, FSB member jurisdictions have committed to:

implementing international financial standards;

undergoing an assessment under the IMF-World Bank Financial Sector Assessment Program (FSAP) every five years;

disclosing their degree of adherence of international standards, notably by publishing the detailed assessments prepared by the IMF and World Bank as a basis for the Reports on the Observance of Standards and Codes (ROSCs); and

undergoing periodic peer reviews using, among other evidence, reports prepared as part of the FSAP.

All 24 FSB member jurisdictions have participated or are in the process of participating in the FSAP ...

An initial FSAP was completed in 20 member jurisdictions (five of which also completed an FSAP Update) and is currently under way in a further three jurisdictions, while an FSAP was not completed in the case of one member jurisdiction.

... FSB member jurisdictions have committed to undergoing periodic peer reviews focused on the implementation and effectiveness of international financial standards and of policies agreed within the FSB. The peer reviews will build on, and avoid duplicating, existing assessment mechanisms, such as FSAPs and ROSCs. The added value of FSB peer reviews will come in significant part from the cross-sector, cross-functional, system-wide perspective brought by its members. Dialogue with peers will be a key benefit of the reviews.

FSB member jurisdictions have agreed to undergo both thematic and country peer reviews. Thematic peer reviews will focus on the implementation across the FSB membership of policies or standards agreed within the FSB, with particular attention to consistency in cross-country implementation and the effectiveness of the policy or standard in achieving the intended results. Country peer reviews will focus on the implementation and effectiveness of financial sector standards and policies agreed within the FSB in achieving the desired outcomes in a specific member jurisdiction, notably through systematic and timely follow up to relevant recommendations arising from an FSAP or ROSC.

FSB peer reviews will be based on reports drafted by small teams composed of experts from FSB member jurisdictions and international bodies, supported by the FSB Secretariat. The substantive review by peers will take place in the Standing Committee on Standards Implementation. The final responsibility for approving FSB peer reviews lies with the Plenary, as the decision-making body of

the FSB. In keeping with the FSB's commitment to lead by example, peer review reports will be published, along with any commentary provided by the reviewed jurisdictions for inclusion. Following publication of the report, jurisdictions' implementation of agreed actions will be monitored by the FSB and, if implementation lags, peer pressure may be applied. Guidelines for the conduct of FSB peer reviews are set out in a Handbook for FSB Peer Reviews that will be revised and expanded as experience is gained.

Thematic and country reviews will move forward in parallel. The first thematic review is on actions taken by firms and national authorities to implement the FSB Principles and Implementation Standards for Sound Compensation Practices. This review will be completed by March 2010. The FSB aims to complete two more thematic reviews and three country reviews in 2010.

...The FSB is finalising procedures to encourage the adherence of all countries and jurisdictions to international financial standards, including by identifying non-cooperative jurisdictions and assisting them to improve their adherence. This initiative responds to a call by G20 Leaders at the April 2009 London Summit and complements initiatives by the Global Forum and OECD to promote adherence to international standards in the tax area, and by FATF for standards concerning anti-money laundering and combating the financing of terrorism.

Of particular concern to the FSB is the adherence of jurisdictions to international cooperation and information exchange standards in the financial regulatory and supervisory area. The three key standards in the regulatory and supervisory area are: the BCBS Core Principles for Effective Banking Supervision; the IAIS Insurance Core Principles; and the IOSCO Objectives and Principles of Securities Regulation.... The initial focus of the FSB is on jurisdictions that could pose a risk to financial stability because of their importance in the financial system and their weak adherence to the relevant standards. Over time, the FSB will reassess this focus and may adjust it to other potential areas of concern or groups of jurisdictions.

The FSB is prioritising a pool of jurisdictions to engage in dialogue in order to further evaluate their adherence to the relevant standards and possible ways to improve adherence. Prioritisation will take place according to available information on jurisdictions' importance in the financial system and on their compliance with the relevant standards.

In order to measure financial importance, a combination of the following economic and financial indicators will be considered to rank jurisdictions:

Domestic financial assets, both in absolute terms and relative to national GDP.

External financial assets and liabilities of a jurisdiction as measured by creditor-side data, specifically the BIS international banking statistics and the IMF Coordinated Portfolio Investment Survey.

Gross capital flows, both in absolute terms and relative to national GDP.

Market share in selected global market segments. Five market segments will be considered: cross-border interbank assets, pension fund assets, hedge fund assets (based on both the location of the manager and the legal domicile of the fund), over-the-counter derivatives markets, and insurance premiums.

The adherence of jurisdictions to the relevant standards will be evaluated using information on



compliance from ROSCs prepared by the IMF and World Bank, and Multilateral Memoranda of Understanding (MMoU). A jurisdiction that is either “compliant” or “largely compliant” in all, or all except one, of the relevant international cooperation and information exchange principles ... will not require further evaluation. In the case of principles in the securities regulation area, signature of the IOSCO MMoU Concerning Consultation and Cooperation and the Exchange of Information will be considered as sufficient evidence of compliance.

All FSB member jurisdictions will be held to the same standard, and be subject to the same evaluation process, as will be applied to non-member jurisdictions. The FSB will actively engage in external outreach and communications to ensure that the process and potential outcomes of this dialogue to promote and strengthen adherence to international standards are fully explained and understood.

The FSB's dialogue with jurisdictions will evaluate areas of weakness, consider cooperation with international assessment processes, examine where further information is needed, identify priorities for reform, and recommend actions to address weaknesses. To support the efforts of low-capacity jurisdictions to achieve adherence with international standards, capacity-building mechanisms will be made available to provide technical assistance. A toolbox of potential measures to promote adherence is being finalised. The toolbox will be a balance of positive and negative measures, and will include the option of publishing by the end of 2010 the names of non-cooperative jurisdictions in the event that other measures to promote adherence to international cooperation and information exchange standards are not achieving sufficient progress.

But the process for implementing these changes is a slow one.<sup>131</sup>

Above (at page 49) I asked whether regulation should aim to discourage speculation. How we might think about this question might depend on our perspective or the reason for asking the question. We might be concerned with the issue whether the actions of speculators damage the markets, or other actors in those markets. For example, European states have been concerned about the impact of speculative trading on their sovereign debt. We might be concerned to limit the costs of bailouts by restricting the activities of insured institutions (e.g. the “Volcker Rule”).<sup>132</sup> Or we might be interested in the question of what legal

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<sup>131</sup> See, e.g., Financial Stability Board, Progress of Financial Regulatory Reforms (Nov. 9, 2010) at [http://www.financialstabilityboard.org/publications/r\\_101109.pdf](http://www.financialstabilityboard.org/publications/r_101109.pdf) ; G-20 Mutual Assessment Process—IMF Staff Assessment of G-20 Policies (Oct. 2010) at <http://www.imf.org/external/np/g20/pdf/111210.pdf> .

<sup>132</sup> See Federal Reserve System, Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 75 Fed. Reg. 72741, 72741 (Nov. 26, 2010)(the Volcker Rule prohibits banking entities from engaging in proprietary trading (as defined by the

protections should be available to investors who engage in speculative or excessively speculative) behavior. The following case illustrates some aspects of this issue in the context of foreign exchange futures transactions.

### Derivatives transactions and risk: *De Kwiatkowski v Bear Stearns*<sup>133</sup>

...Kwiatkowski first opened an account at Bear Stearns in 1988, when his broker, Albert Sabini, relocated there from the defunct E.F. Hutton firm. The account was handled by Bear's "Private Client Services Group," which provides large private investors with enhanced services, including access if requested to the firm's executives and financial experts. As a member of this group, Sabini was in regular contact with Kwiatkowski, often communicating several times a day. Sabini provided his client with news and market reports, and sometimes sent him Bear Stearns documents containing market forecasts and investment recommendations.

At first, Kwiatkowski's account at Bear was limited to securities trading. His currency trading was conducted through Bank Leu, a bank in the Bahamas, where Kwiatkowski maintained his principal residence. In January 1991, Kwiatkowski opened a futures account at Bear by transferring from Bank Leu a position consisting of 4000 Swiss franc short contracts traded on the Chicago Mercantile Exchange ("CME"). Kwiatkowski effected the transfer because he thought Bear would be better able to service the account, Sabini having "extolled the capacity of Bear Stearns to provide him the full services and resources he needed for large-scale foreign currency trading.".... The Private Client Services Group provided its clients with access to Bear's financial experts and executives...and advertised "a level of service and investment timing comparable to that which [Bear] offered [its] largest institutional clients."...

Kwiatkowski's futures account at Bear was at all times "nondiscretionary," meaning that Bear executed only those trades that Kwiatkowski directed. When the account was opened in January 1991, Kwiatkowski signed a number of documents and risk-disclosure statements (some of which were mandated by federal regulations). These reflect in relevant part that:

- . Kwiatkowski declared his net worth to be in excess of \$ 100 million, with liquid assets of \$ 80 million;
- . He was warned that "commodity futures trading is highly risky" and a "highly speculative activity," that futures "are purchased on small margins and . . . are subject to sharp price movements," and that he should "carefully consider whether such [futures] trading is suitable for [him]";
- . He was warned that because, under some market conditions, he "may find it difficult or impossible to liquidate a position"--meaning that he "may sustain a total loss" of his posted collateral--he should

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Volcker Rule) or from acquiring or retaining any ownership interest in, or sponsoring, a hedge fund or private equity fund... The Volcker Rule, however, also expressly provides certain exceptions from these prohibitions...")

<sup>133</sup> 306 F.3d 1293 (2d. Cir., 2002)

"constantly review [his] exposure . . . and attempt to place at risk only an amount which [he knew he could] afford to lose";

. He was warned that if he chose to trade on margin, he could lose more than what he posted as collateral;

. He gave Bear a security interest in all his accounts at the firm, authorized Bear to transfer funds from his other account to his futures account if necessary to avoid margin calls, and authorized Bear to protect itself by liquidating his futures account if Kwiatkowski failed to meet margin requirements.

Kwiatkowski's trading strategy reflected his belief in the long-term strength of the U.S. dollar. As he testified at trial, he had believed "the dollar should appreciate" over time, though he conceded that he always understood that the dollar would experience "ups and downs" in the near term...

Kwiatkowski had been an experienced currency trader before he opened his Bear Stearns futures account. As an entrepreneur and founder of Kwiatkowski Aircraft- which leases and sells airplanes internationally – he developed a background in trading to hedge the risks associated with his company's foreign currency transactions. Kwiatkowski also had experience betting on the dollar in hopes of earning speculative profit. In 1990, shortly before transferring his Bank Leu position to Bear Stearns, Kwiatkowski lost nearly \$ 70 million in that account when the dollar declined against the German mark and Swiss franc.

Before Kwiatkowski did his first currency transaction at Bear in September 1992, he met with Bear's then-Chief Economist, Lawrence Kudlow, who expressed the view that the dollar was undervalued worldwide and therefore was a good investment opportunity. In the weeks following this meeting, Kwiatkowski executed several trades betting on the rise of the dollar, ultimately acquiring 16,000 open contracts on the CME. He closed his position in January 1993, having made \$ 219 million in profits in about four months. At trial, Kwiatkowski testified that he consulted Bear prior to liquidating: "We discussed it and they thought the advisement was a change of feelings about it." ... The record is vague as to who at Bear said what, but (construing ambiguities in Kwiatkowski's favor) a fair reading is that Kwiatkowski was encouraged by someone at Bear to liquidate his position.

Kwiatkowski's futures account was dormant between January 1993 and October 1994. Kwiatkowski testified that in an October 1994 phone call, Sabini told him that "this is the time to buy the dollar," and that "this time the dollar will do what [Kwiatkowski] always believed it would do." .. Kwiatkowski began aggressively short-selling the Swiss franc, the British pound, the Japanese yen, and the German mark. Within a month, Kwiatkowski amassed 65,000 contracts on the franc, pound, yen, and mark in equal proportions--a position with a notional value of \$ 6.5 billion... All of the transactions were executed on the CME. At one point, Kwiatkowski's position amounted to 30 percent of the CME's total open interest in some of the currencies. According to David Schoenthal, the head of Bear Stearns Forex, Kwiatkowski's position was more than six times larger than any other position Schoenthal had ever seen in 27 years on the CME...

In mid-November 1994, after Kwiatkowski had acquired the bulk of his position (approximately 58,000 contracts), Sabini sent him a copy of a report by Wayne Angell, then-Chief Economist at Bear, entitled "Dollar Investment Opportunity," expressing the view that the dollar was still undervalued.

According to Kwiatkowski, the report influenced him to "roll over" his entire 65,000-contract position past the December date on which the contracts came due.

Like many speculative investors, Kwiatkowski traded on margin, meaning he put up only a fraction of the \$ 6.5 billion notional value, as specified by the brokerage firm. As the dollar fluctuated, Kwiatkowski's position was "marked-to-market," meaning that his profits were added to his margin and his losses were deducted. As he earned profits, his margin increased, meaning he could opt (as he did) to have profits paid out to him daily; when losses reduced his margin, Kwiatkowski was compelled to meet the margin requirement by depositing more money or by liquidating contracts. Thus, while Kwiatkowski put up only a small percentage of the notional value (well under ten percent, which is apparently not unusual), his personal profits and losses reflected the full \$ 6.5 billion position, and magnified vastly the slightest blip in the dollar's value.

As Kwiatkowski acquired his colossal position in the volatile futures market, Bear took precautions. In November 1994, the firm's Executive Committee and senior managers assumed oversight of Kwiatkowski's account. Bear also required Kwiatkowski to increase his posted margin collateral to \$ 300 million in cash and liquid securities.

In late November or early December, Schoenthal told Bear's Executive Committee that Kwiatkowski's position was too conspicuous on the CME to allow a quick liquidation, and (with Sabini) recommended to Kwiatkowski that he move his position to the over-the-counter ("OTC") market, the unregulated international commodities market whose traders generally consist of governments and large financial institutions. Schoenthal told Kwiatkowski that he could trade with less visibility on the larger and more liquid OTC market, and more easily liquidate without impacting the market. According to Kwiatkowski, Schoenthal told him that, when and if Kwiatkowski needed to liquidate, Schoenthal could get him out of the OTC market "on a dime." ... Kwiatkowski accepted Schoenthal's recommendation in part: when it came time to roll over his contracts in early December, Kwiatkowski moved half of them to the OTC market.

By late January 1995, Kwiatkowski's account had booked breathtaking gains and losses. As of December 21, 1994 -- less than two months after he resumed currency speculation at Bear -- Kwiatkowski had made profits of \$ 228 million. When the dollar fell a week later, Kwiatkowski lost \$ 112 million in a single day (December 28). When the dollar fell again, on January 9, 1995, Kwiatkowski lost another \$ 98 million. Ten days later, on January 19, he lost \$ 70 million more. After absorbing these hits, Kwiatkowski was still ahead \$ 34 million on his trades since October 28, 1994.

As the dollar fell, Kwiatkowski consulted with Bear at least three times. After the December 28 shock, Kwiatkowski told Schoenthal and Sabini he was concerned about the dollar and was thinking of closing his position. They advised him that it would be unwise to liquidate during the holiday season, when the markets experience decreased liquidity and prices often fall... The dollar rebounded on December 29, and Kwiatkowski recouped \$ 50 million of the previous day's losses.

After the January 9 decline, Kwiatkowski spoke with Sabini and Wayne Angell, Bear's Chief Economist. According to Kwiatkowski, Angell thought that the dollar remained undervalued and would bounce back. Kwiatkowski decided to stand firm. In late January, he spoke with Schoenthal about the

U.S. Government policy of strengthening the Japanese yen, and afterward Kwiatkowski liquidated half of his yen contracts.

The dollar remained volatile through the winter, due in large part (it was thought) to geopolitical currents. Two salesmen in Bear's futures department, William Byers and Charles Taylor, who wrote a monthly report called Global Futures Market Strategies, announced in their February 1995 issue that they were downgrading the dollar's outlook to "negative," principally because of the Mexican economic crisis, certain steps taken by the Federal Reserve Board, and an anticipated increase in German interest rates. The report cited the German mark and the Swiss franc as especially likely to strengthen--two of the currencies in which Kwiatkowski held short positions. Kwiatkowski testified that he never received a copy of this report...

As of February 17, Kwiatkowski was down \$ 37 million since October 1994. In mid-February, rather than deposit more cash, Kwiatkowski instructed Bear to meet future margin calls by liquidating his contracts. As the dollar declined, Bear gradually liquidated Kwiatkowski's position (obtaining his approval of each trade). By the close of business on Thursday, March 2, 1995, Kwiatkowski's total position had been reduced to 40,800 contracts in the Swiss franc and the German mark. He had suffered net losses of \$ 138 million in slightly over four months.

Over the next three days, the dollar fell sharply against both the franc and the mark, and Kwiatkowski's remaining contracts were liquidated at a further loss of \$ 116 million.

On the morning of Friday, March 3, Bear tried to reach Kwiatkowski for authorization to liquidate 18,000 of his contracts in order to meet a margin call. Kwiatkowski was unavailable, so (as the account agreement allowed) Bear effected the liquidation unilaterally and secured Kwiatkowski's approval later that day. At that time, Kwiatkowski expressed interest in liquidating his position altogether. Schoenthal and Sabini advised Kwiatkowski that because market liquidity generally lessens on Friday afternoons, it would be prudent to hold on and take the chance that the dollar would strengthen... According to Kwiatkowski, he relied on this advice in deciding to hold on to the balance of his contracts.

When the overseas markets opened on Sunday (New York time), the dollar fell. Schoenthal was in his office to monitor Kwiatkowski's account and was in touch with Kwiatkowski throughout the day, obtaining Kwiatkowski's authorization for necessary liquidating trades. By the early hours of Monday, the liquidation was complete. In order to cover his losses, Kwiatkowski was forced to liquidate his securities account and pay an additional \$ 2.7 million in cash...

In all, Kwiatkowski suffered a net loss of \$ 215 million in his currency trading from October 1994 through Monday, March 6, 1995. At trial, Kwiatkowski's expert witness testified that Kwiatkowski could have saved \$ 53 million by liquidating on Friday, March 3. The same expert surmised that \$ 116.5 million would have been saved if Kwiatkowski had liquidated on Wednesday and Thursday, March 1 and 2.

#### B. Proceedings in the District Court

...At trial, Kwiatkowski contended that Bear had breached its duties in three ways: [1] Bear failed

adequately to advise him about unique risks inherent in his giant currency speculation; [2] Bear failed to provide him with market information and forecasts, generated by Bear personnel, that were more pessimistic about the dollar than views Kwiatkowski was hearing from others at Bear; and [3] Bear should have advised Kwiatkowski well before March 1995 to consider liquidating his position, and specifically should have advised him on Friday, March 3 to liquidate immediately rather than hold on through the weekend...

The jury found Bear liable on the negligence claim, and awarded Kwiatkowski \$ 111.5 million in damages. It found for Bear on the breach of fiduciary duty claim, and for Sabini on both claims (verdicts from which no appeals have been taken)...The district court ... rul[ed]... that the evidence supported the finding of an "entrustment of affairs" to Bear that included "substantial advisory functions," and that the services that Bear provided "embodied the full magnitude of 'handling' Kwiatkowski's accounts, with all the considerable implications that such responsibility entailed."...

#### Discussion

We must decide whether the facts of this case support the legal conclusion that Bear Stearns as broker owed its nondiscretionary customer, Kwiatkowski, a duty of reasonable care that entailed the rendering of market advice and the issuance of risk warnings on an ongoing basis. If so, we must decide whether a reasonable juror could find that Bear breached that duty.

It is uncontested that a broker ordinarily has no duty to monitor a nondiscretionary account, or to give advice to such a customer on an ongoing basis. The broker's duties ordinarily end after each transaction is done, and thus do not include a duty to offer unsolicited information, advice, or warnings concerning the customer's investments. A nondiscretionary customer by definition keeps control over the account and has full responsibility for trading decisions. On a transaction -by-transaction basis, the broker owes duties of diligence and competence in executing the client's trade orders, and is obliged to give honest and complete information when recommending a purchase or sale. The client may enjoy the broker's advice and recommendations with respect to a given trade, but has no legal claim on the broker's ongoing attention. See, e.g., *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 536 (2d Cir. 1999) (broker's fiduciary duty is limited to the "narrow task of consummating the transaction requested")... As the district court observed, these cases generally are cast in terms of a fiduciary duty, and reflect that a broker owes no such duty to give ongoing advice to the holder of a nondiscretionary account.

The giving of advice triggers no ongoing duty to do so. See, e.g., *Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc.*, 769 F.2d 561, 567 (9th Cir. 1985) (securities broker had no duty to provide customer with information about stock after purchase was complete)...

From these principles, Bear argues that: it had no ongoing duty to give Kwiatkowski financial advice about his dollar speculation; its sole obligation was to "execute [Kwiatkowski's] transactions at the best prices reasonably available and . . . offer honest and complete information when recommending [a] purchase or sale"; and it had no "open-ended duty of reasonable behavior, or to provide such investment advice as a trier of fact decides would have been prudent." As Bear points

out, Kwiatkowski makes no claim that any of his instructions were improperly carried out, or that he was given dishonest or incomplete information about any trade. Thus, when the district court instructed the jury to evaluate Bear's overall conduct according to whatever a "reasonable broker" would have done under the circumstances, Bear argues, it allowed the jury to enforce advisory obligations that do not exist.

This argument, addressed to the features of nondiscretionary accounts, misses the point. The theory of the case is that this was no ordinary account (an observation that is true enough as far as it goes). Kwiatkowski contends that in the course of dealing, Bear voluntarily undertook additional duties to furnish information and advice, on which he came to rely (as Bear surely knew); that his trading losses were caused or enlarged by Bear's failures to perform those duties; and that Bear's liability arises from generally applicable tort rules requiring professionals to exercise due care in performing whatever services they undertake to provide, as measured against the standard observed by reasonable and prudent members of the profession.

II

The district court acknowledged the general principles limiting a broker's duties to a nondiscretionary customer: it agreed that "in the ordinary situation, the broker's professional obligation to the customer with respect to any particular investment ends upon the completion of the authorized transaction."... Moreover, "as regards a nondiscretionary account, the customer retains management and control over investment transactions, determining what purchases and sales to make. For the purposes of assessing the broker's role and ascribing attendant legal duties, each transaction is considered separately." ... But the court rejected what it called the "mechanical" argument that the nondiscretionary label disposed of Kwiatkowski's claim... (noting that if "a mere recitation of bare legal maxims were all there was to this matter, the action would present only an easy, garden-variety dispute"). The court observed that the cases that articulate the general rules also allude to "special circumstances" that may "exempt the particular action from the scope of the general standard." ...

The court characterized Bear's position as a "per se defense" that a broker's duties to a nondiscretionary customer "not only exclude any obligation to offer advice, but may not even embrace a duty of ordinary, reasonable care."... Reviewing principles of contract, negligence, and agency law, as well as case law concerning the broker/client relationship ... the district court concluded that, on the contrary, "a legal foundation exists which supports application of the duty of care to the broker/customer relationship between Kwiatkowski and Bear Stearns." ...

The court contrasted the general duty of due care with the duties that arise from the parties' intentional relationship, which the court agreed are limited and narrowly defined:

"The duty of due care arises not by agreements or imposition of the parties governing their relations, but by operation of law. The duty emerges out of a totality of given circumstances and holds the defendant in an action to a standard of conduct designed to protect persons located within a reasonable zone of foreseeability who were injured by a defendant's careless behavior. "...

The court explained that "contractual commitments cannot serve to excuse carelessness or

shield a defendant from liability for injury that a breach of the duty of due care may engender." ... Just as "exceptional conditions" may create fiduciary duties without the parties' "express intent," and notwithstanding a contractual disclaimer... the court reasoned that "extraordinary events" may "support imposition of a duty of reasonable care arising from aspects of the same conduct on the part of the broker," ... Such an extraordinary situation may arise from the "assumption, by promise or partial performance, of certain responsibilities under certain conditions...(citing the example of good samaritan liability)...

The district court further ruled that the breach of the duty of care could "be evidenced by Bear Stearns's failure to provide particular information essential to the affairs entrusted and which under all the circumstances a reasonable broker exercising ordinary care would have supplied to the client." ... The court indicated that a duty of care arose by virtue of the broker-client relationship itself, but also specifically considered that a duty of reasonable care arises when the parties depart from the usual rules of a nondiscretionary account, such as where the broker undertakes performance of additional functions. Consistent with this view, the jury was charged both that Bear had a general duty to behave as a reasonable broker.. and that the jury should decide what functions Bear undertook and (thereby) had a duty to perform with reasonable care...

Accordingly, the court ruled that the jury's verdict was sustainable on any one of several findings supportable by the record and the charge:

. Bear assumed substantial advisory functions that made it the "handler" of Kwiatkowski's account ... and that amounted to special circumstances sufficient to impose an ongoing duty of reasonable care...

. Even absent special circumstances, Bear breached the standard of care applicable to the ordinary broker/client relationship by the following: Bear's execution of Kwiatkowski's large trades in the fall of 1994 without conducting new risk and suitability analyses... possible noncompliance with internal Bear procedures concerning notification to the client of increased risk... the initial placement of Kwiatkowski's position on the CME rather than the OTC market... giving overly optimistic advice (specifically, Schoenthal's statement that he could get Kwiatkowski out of the OTC market "on a dime," and Angell's opinion that the dollar was undervalued) in conjunction with the failure to furnish other, negative dollar forecasts... and the handling of the liquidation in March 1995...

. Even if Bear had no standing obligation (under ordinary or special circumstances) to provide Kwiatkowski with assistance, Bear nonetheless undertook to do so in connection with the March liquidation, and did so in a manner that was imprudent and that actually worsened Kwiatkowski's situation...

### III

No doubt, a duty of reasonable care applies to the broker's performance of its obligations to customers with nondiscretionary accounts. See, e.g., *Conway v. Icahn & Co., Inc.*, 16 F.3d 504, 510 (2d Cir. 1994)...

The claim of negligence in this case, however, presupposes an ongoing duty of reasonable



care (i.e., that the broker has obligations between transactions). But in establishing a nondiscretionary account, the parties ordinarily agree and understand that the broker has narrowly defined duties that begin and end with each transaction. We are aware of no authority for the view that, in the ordinary case, a broker may be held to an open-ended duty ... of reasonable care, to a nondiscretionary client, that would encompass anything more than limited transaction-by-transaction duties. Thus, in the ordinary nondiscretionary account, the broker's failure to offer information and advice between transactions cannot constitute negligence.

All of the cases relied on by Kwiatkowski in which brokers have been found liable for their nondiscretionary customers' trading losses involve one or more of the following: unauthorized measures concerning the customer's account (i.e., the account became discretionary-in-fact because the broker effectively assumed control of it); failure to give information material to a particular transaction; violation of a federal or industry rule concerning risk disclosure upon the opening of the account; or advice that was unsound, reckless, ill-formed, or otherwise defective when given...

Kwiatkowski does not claim any unauthorized trading, any omission of information material to a particular transaction, any violation of government or industry regulations concerning risk disclosures at the time he opened his account, or (except for Schoenthal's advice that he not liquidate on Friday, March 3, 1995) any unsound or reckless advice. Indeed (with that exception, discussed *infra*), Kwiatkowski is in no position to complain about any of these things. He can hardly contend that Bear negligently induced his speculations in the dollar (Kwiatkowski made early profits in excess of \$ 200 million); or that Schoenthal was negligent in advising him to move the position to the OTC market (he claims that Bear was negligent in failing to give him that advice in the first place); or that Schoenthal was negligent in advising him after the late-December loss that the dollar would probably bounce back (Kwiatkowski made about \$ 50 million the following day). Kwiatkowski does not allege that any of this advice was given negligently or in bad faith; he does not even allege that it was bad advice--nor could he, given the immense profits he made when he acted on it.

In sum, aside from the March liquidation, the claimed negligence is not in the advice that Bear gave, but in advice that Bear did not give. Specifically, Kwiatkowski finds a breach of duty in: [1] Bear's failure to volunteer certain advice, namely the Byers-Taylor prediction in early 1995 that the dollar was likely to fall; [2] Bear's failure to advise him, on an ongoing basis, of risks associated with his dollar speculation; and [3] Bear's negligence in connection with the March 1995 liquidation.

Kwiatkowski does not dispute that in the ordinary case, a broker's failure to offer ongoing, unsolicited advice to a nondiscretionary customer would breach no duty. Kwiatkowski's claim is viable, therefore, only if there is evidence to support his theory that Bear, notwithstanding its limited contractual duties, undertook a substantial and comprehensive advisory role giving rise to a duty on Bear's part to display the "care and skill that a reasonable broker would exercise under the circumstances."

We conclude that the district court's judgment must be reversed because there was insufficient evidence to support the finding that Bear undertook any role triggering a duty to volunteer advice and warnings between transactions, or that Bear was negligent in performing those services it

did provide. Liability cannot rest on Bear's failure to give ongoing market advice that it had no duty to give, on Bear's failure to issue warnings that it had no duty to give (concerning risks about which Kwiatkowski surely knew more than anyone), or on Bear's failure to foretell the short-term gyrations of the dollar.

#### 1. Advice

Kwiatkowski points to the advice he received from Bear, both solicited and unsolicited. There is certainly ample evidence that Kwiatkowski transferred his account to Bear's Private Client Services Group in part to get (as Bear advertised) access to the firm's top financial analysts and experts. And he received it. The record also supports inferences that Bear encouraged Kwiatkowski's betting on the dollar, that he moved half his position to the OTC market on the strength of Schoenthal's advice, that twice he decided against liquidating his position at least in part because of Bear's advice that the dollar was still undervalued, and that he followed Schoenthal's advice against trying to liquidate on the afternoon of Friday, March 3, 1995...

But the giving of advice is an unexceptional feature of the broker-client relationship. What little case law there is on the subject makes clear that giving advice on particular occasions does not alter the character of the relationship by triggering an ongoing duty to advise in the future (or between transactions) or to monitor all data potentially relevant to a customer's investment...

A broker may be liable in tort... for breach of a duty owed in respect of advice given. But if a broker had a broad duty to furnish a nondiscretionary customer with all advice and information relevant to an investment, then, as the Robinson court observed, the customer could recover damages "merely by proving nontransmission of some fact which, he could testify with the wisdom of hindsight, would have affected his judgment had he learned of it." ...

Thus if Bear had a duty to advise Kwiatkowski in early 1995 that the dollar might fall, it could not arise merely because Bear advised him in late 1994 that the dollar might rise. Kwiatkowski characterizes Bear's frequent giving of advice as an "undertaking" that supports a generalized duty of reasonable care to perform ongoing advisory duties not created by contract. The advisory services that Bear advertised and provided to Kwiatkowski, however, were wholly consistent with his status as a nondiscretionary customer; Kwiatkowski bargained for the expertise of the Private Client Services Group, but he simultaneously signed account agreements making clear that he was solely responsible for his own investments. It was thus obviously contemplated that Kwiatkowski would receive a lot of advice from Bear's senior economists and gurus, and that this advice would not amount to Bear's entrustment with the management of the account. It follows that Kwiatkowski cannot reasonably have believed that once he sought and Bear gave advice, Bear had become "account handler."

Any duty by Bear to offer advice therefore could arise only if the law, under the circumstances of this case, imposes on Bear some special duty as a result of the relationship between the parties – that is, if Kwiatkowski's account deviated from the usual nondiscretionary account in a way that creates a special duty beyond the ordinary duty of reasonable care that applies to a broker's actions

in nondiscretionary accounts. The district court alluded to "special circumstances," in particular Kwiatkowski's outsized account, the frequency of broker contacts, and the unique risk run by a private individual speculating in currency on a scale known only to governments of large countries...

These circumstances made Kwiatkowski's account special, even very special; but these circumstances are not special in a way that transforms the account relationship. The transformative "special circumstances" recognized in the cases are circumstances that render the client dependent – a client who has impaired faculties, or one who has a closer than arms-length relationship with the broker, or one who is so lacking in sophistication that de facto control of the account is deemed to rest in the broker. The law thus imposes additional extra-contractual duties on brokers who can take unfair advantage of their customers' incapacity or simplicity...

Kwiatkowski of course is the very opposite of the naive and vulnerable client who is protected by "special circumstances." He was a special customer chiefly by reason of his vast wealth, his trading experience, his business sophistication, and his gluttonous appetite for risk. These factors weigh strongly against--and not at all in favor of--heightened duties on the part of the broker (as suitability rules in other contexts imply... We therefore conclude that the theory of "special circumstances" does not broaden the scope of Bear's undertaking...

## 2. Risk

When Kwiatkowski opened his account, Bear warned him of the risks of currency trading. Kwiatkowski argues that Bear should have given further specific warnings throughout the relevant period concerning "extraordinary market and liquidity risks" posed by the size of his position, especially in conjunction with market changes and the volatility of the dollar. Kwiatkowski's argument fails because he has not demonstrated that Bear was under an obligation to provide the warnings he claims were omitted, because he grossly understates the warnings Bear in fact issued and the impact such warnings would have had on any reasonable investor, and because (even if Bear failed to give warnings it was obliged to give) as a matter of law, Kwiatkowski's trading losses were not caused by any insufficiency of warnings.

Under the written terms of Kwiatkowski's currency futures account, Bear undertook to serve as "futures commission merchant" ("FCM") (for the trades placed on the CME) and as "OTC dealer" (for the trades placed on the over-the-counter market), and in no other capacity. Bear did not in this case contract to serve in an advisory capacity (at least with respect to Kwiatkowski's futures account), and thus (undisputedly) was neither an "investment adviser" as defined by the Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11), nor a "commodity trading adviser" as defined by the Commodities Exchange Act, 7 U.S.C. § 1a(6).

As an FCM, Bear was subject to regulations promulgated by the Commodity Futures Trading Commission ("CFTC") and by the National Futures Association ("NFA"), a self-regulatory organization registered with the CFTC. (Bear is an NFA member, as all FCMs must be.) At the time Kwiatkowski opened his account, Bear as FCM had certain obligations: pursuant to CFTC Rule 1.55, Bear was to provide Kwiatkowski with a detailed risk disclosure statement, see 17 C.F.R. §

1.55(a),(b); and pursuant to NFA Compliance Rule 2-30, Bear was to obtain from Kwiatkowski a variety of personal information, including his net worth, estimated annual income, and previous experience in futures trading. It is undisputed that Bear did these things.

But, as Kwiatkowski argues, there is trial evidence to show that industry standards--even Bear's own internal policies--may have demanded something more. For example, New York Stock Exchange ("NYSE") Rule 405, the "know your customer" rule, provides (inter alia) that the broker must "use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried . . . ."... Although Rule 405 does not apply to commodities brokers, Sabini testified that in practice Bear adhered to that rule in the commodities context. Moreover, Sabini understood the rule to require the broker to undertake a new risk analysis every time a customer's investment position materially changed... Kwiatkowski argues further that the minimum requirements established by NFA Rule 2-30 understate industry practice ... and he cites administrative decisions of the CFTC indicating that FCMs, in certain circumstances (depending on the nature of the broker-client relationship), may have risk-disclosure obligations that go beyond CFTC Rule 1.55... In sum, Kwiatkowski argues that Bear's negligence is evidenced by industry practice and internal Bear rules indicating that Bear should have provided more than it did in the way of risk warnings and account monitoring.

We disagree. First, the CFTC cases on which Kwiatkowski relies are exemplars of the "special circumstances" that some courts have cited to justify departure from ordinary rules--circumstances, as we noted above, that have nothing to do with Kwiatkowski...

Second, deviation from industry or internal standards for monitoring risk and suitability does not necessarily amount to the breach of a duty owed to Kwiatkowski. The general rule (as we have emphasized) is that commodities brokers do not owe nondiscretionary clients ongoing advisory or account-monitoring duties, such as the duty to warn of changes in market conditions or other information that can impact the client's investments.

As a policy matter, it makes no sense to discourage the adoption of higher standards than the law requires by treating them as predicates for liability. Courts therefore have sensibly declined to infer legal duties from internal "house rules" or industry norms that advocate greater vigilance than otherwise required by law...

Kwiatkowski cites no competing authority; indeed he does not argue directly that noncompliance with internal rules or industry standards is a basis for liability. Kwiatkowski instead relies on such noncompliance as evidence of Bear's overall failure to exercise due care. The district court agreed...

It may be that noncompliance with internal standards could be evidence of a failure to exercise due care, assuming however a duty as to which due care must be exercised. But the assertion that Bear had an ongoing duty to exercise "due care" or "behave like a reasonable broker," breach of which could be evidenced by noncompliance with internal rules, cannot be squared with the cases holding that a broker's obligations to a nondiscretionary client arise and are satisfied transaction-by-transaction. And, as illustrated above, there is no basis in this case for a more

comprehensive duty on Bear's part to monitor Kwiatkowski's account between transactions. He cites the frequent advice from senior economists at Bear. But giving advice is consistent with the limited duties owed by a broker to the holder of a nondiscretionary account. And though Kwiatkowski's account was enormous, and he could therefore elicit such advice more frequently and from the most senior persons in the firm, the service rendered by Bear was not different in kind.

Kwiatkowski can succeed therefore only if the district court was correct that some "special circumstances" justify imposing extraordinary duties on Bear. We have already explained why Kwiatkowski is the very opposite of the type of client protected by that very limited doctrine. We therefore conclude that Bear had no ongoing duty to give advice and warnings concerning his investments.

Kwiatkowski contends that Bear did "literally nothing" to advise him of the distinct risks he was facing. This claim wholly ignores Bear's advice in late 1994 that Kwiatkowski was too visible on the CME because of the size of his position, and that he should move to the OTC market generally favored by governments and banks. It is hard to conceive of a clearer signal to an experienced investor that the account is exposed and unique. n 19

n19 The fact that Kwiatkowski only partially accepted this advice (he moved half his contracts to the OTC) also defeats any inference that he entrusted account -shepherding functions to Bear that could trigger on ongoing duty of reasonable care. See, e.g., *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1029 (4th Cir. 1997) (customer's rejection of broker's advice on some occasions demonstrated that customer made independent investment decisions).

Finally, even if one could say that Bear breached a duty to advise Kwiatkowski of certain additional risks, that breach could not (as a matter of law) have caused Kwiatkowski's losses. Kwiatkowski could have been under no illusions about his situation after January 19, 1995. In the three weeks preceding that date, he had suffered single-day losses of \$ 112 million, \$ 98 million, and \$ 70 million. Kwiatkowski could not have mistaken his trading account for an annuity. Yet, despite these blows, he could have walked away on January 19, 1995 with a net profit of \$ 34 million from three months of trading. At this point, when Kwiatkowski decided to press on, there was nothing that Bear could tell him about the risks that he did not know from experience.

Kwiatkowski has two further points that merit brief consideration. First, Kwiatkowski cites the failure of the firm to mail him the February 1995 Byers-Taylor report downgrading the dollar to "negative." Assuming that Kwiatkowski would have read and been influenced by the report, and assuming further that Bear was obliged to send him that particular report, this argument misconceives the nature of the risk that Kwiatkowski faced-and welcomed. Kwiatkowski knew that the dollar would experience short-term "ups and downs," and he certainly knew that market liquidity was variable and that he could experience massive losses quickly. He made and lost millions of dollars virtually every day. Yet Kwiatkowski nevertheless built a position that exposed him to disaster at any moment by

reason of developments anywhere and everywhere on earth that could not have been predicted by Bear even if it had volunteered all of its information and predictions. Kwiatkowski knew--at the very least, he should have known after December 28, 1995 (the day he lost \$ 112 million)--that even within a long-term upswing, a severe enough down-tick could wipe him out. Accordingly, it would be pure speculation to find that the delivery of one long-term forecast would have rendered Kwiatkowski risk-averse.

Kwiatkowski also argues that he was misled concerning his ability to liquidate quickly by Schoenthal's statement that he could get out of the OTC market "on a dime." This argument cannot bear the weight Kwiatkowski puts on it. There is no dispute that Schoenthal's advice was sound: The OTC market was preferable to the CME (though, as it happened, Kwiatkowski only half-followed this advice). Nothing suggests that Kwiatkowski fared worse because of this move than he would have if he had left his contracts on the CME... He could not reasonably have believed that "on a dime" meant that billions of dollars in contracts could be folded instantaneously and without loss. The phrase is hyperbole. No one could reasonably bet millions on the idea that it meant immediate liquidity all the time, certainly not Kwiatkowski after he had been warned over the holidays that liquidation sometimes could be difficult even on the OTC market...

#### Conclusion

For the reasons stated, we reverse the judgment of the district court and remand for entry of judgment dismissing the complaint.

#### **Why would an investor open a “non-discretionary” account? Would upholding the District Court’s decision have caused any problems?**

Note that the court refers to Kwiatkowski's circumstances as involving “the unique risk run by a private individual speculating in currency on a scale known only to governments of large countries.”<sup>134</sup> The court also refers to him as “the very opposite of the naive and vulnerable client who is protected by "special circumstances." He was a special customer chiefly by reason of his vast wealth, his trading experience, his business sophistication, and his gluttonous appetite for risk. These factors weigh strongly against--and not at all in favor of--heightened duties on the part of the broker (as suitability rules in other contexts imply).”<sup>135</sup>

#### **Do you agree that these factors should weigh against liability for Bear Stearns in this**

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<sup>134</sup> See p [75](#) above.

<sup>135</sup> See p [75](#) above.

**case? Is there a credible argument that Kwiatowski's behavior shows that he needed more protection than he received?**

De Kwiatkowski tried to claim that Bear Stearns owed him duties which he had breached. Another way of protecting investors is through a regulatory regime. Under the Dodd-Frank Act the CFTC has jurisdiction to regulate the foreign exchange market. Announcing new regulations in August 2010<sup>136</sup> the Chairman of the CFTC, Gary Gensler stated "These rules of the road will help protect the American public in the largest area of retail fraud that the CFTC oversees: retail foreign exchange... All CFTC registrants involved in soliciting and selling retail forex contracts to consumers will now have to comply with rules to protect the investing public. This is also the first final rule that the Commission has published to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act. We look forward to publishing additional rules to protect the American public."<sup>137</sup> The new rules aim to protect retail customers,<sup>138</sup> and would not apply to a person as wealthy as De Kwiatkowski. The rules regulate security deposits required of retail investors in foreign exchange transactions:

In general terms, proposed Regulation 5.9 would have required FCMs and RFEDs engaging in retail forex transactions to collect from each retail forex customer a minimum security deposit equal to 10 percent of the notional value of each retail forex transaction. This proposal is often referred to in

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<sup>136</sup> CFTC, Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. 55410 (Sep. 10, 2010) ; CFTC, Performance of Registration Functions by National Futures Association With Respect to Retail Foreign Exchange Dealers and Associated Persons, 75 Fed. Reg. 55310, 55311 (Sep. 10, 2010) ("Specifically, the CRA gives the Commission the authority to require the registration of intermediaries who solicit retail customers to participate in off-exchange forex contracts, who pool customer money for the purpose of trading off-exchange currency contracts or who manage customer money for this purpose. In the final rules published today, the Commission has determined that these entities should be registered in the existing categories of introducing broker ("IB"), commodity pool operator ("CPO"), or commodity trading advisor ("CTA"), as appropriate.")

<sup>137</sup> CFTC Releases Final Rules Regarding Retail Forex Transactions (Aug. 30, 2010) at <http://www.cftc.gov/PressRoom/PressReleases/pr5883-10.html> .

<sup>138</sup> "Generally, retail customers are: • Individuals with less than \$10 million in total assets, or less than \$5 million in total assets if entering into the transaction to manage risk, and who are not registered as futures or securities professionals; • Companies, other than financial institutions and investment companies, with less than \$10 million in total assets, or a net worth less than \$1 million if entering into the transaction in connection with the conduct of their businesses; and • Commodity pools that have less than \$5 million in total assets."  
[http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/forexfinalrule\\_qa.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/forexfinalrule_qa.pdf).

the comment letters as a 10% or 10:1 leverage requirement (i.e., for every \$10 of notional value, \$1 is required as a security deposit).

The Commission received a significant number of comment letters regarding the Security Deposit Proposal with a substantial majority of the commenters objecting to the proposed level of 10%. Many of the letters submitted with regard to this issue appeared to be submitted by individual traders, were identical or nearly identical, and objected generally to the proposal. Within the large group of comments by such traders, whether in “form” letter objections or otherwise, the most common objections were that the leverage proposal would drive business off-shore, would lead to the loss of jobs in the U.S., was unnecessarily restrictive and would inhibit small traders’ ability to trade profitably, or that the percentage required as a security deposit was arbitrary, capricious and anti-competitive

Other commenters noted that by increasing the security deposit level, retail forex customers are exposed to greater levels of market and credit risk. Many of these commenters believe that the amplification that is provided by increased leverage is necessary for clients to earn a profit from their positions. Still other commenters urged that NFA’s current levels be retained and asserted that the Commission had already approved these levels by allowing NFA’s proposed rule regarding leverage to become effective. Finally, one commenter encouraged the Commission to (1) recognize the different market risks and volatility posed by different currencies, (2) adopt requirements reflective of those differences just as contract markets do in establishing their margin levels, and (3) endorse or adopt some mechanism to allow for periodic review and adjustment of the requirements if necessary.

The Commission’s proposed leverage restriction was conservative and was proposed in an effort to provide maximum customer protection. The Commission does not, however, believe it was arbitrary or contrary to previously approved NFA rules. Moreover, the Commission does not believe that most retail foreign exchange customers select a counterparty based solely on the maximum allowable leverage, otherwise these investors would have already migrated to foreign markets, some of which have no limitation on leverage. Nevertheless, after considering the concerns expressed and arguments made in the comments, the Commission has determined to adopt a revised security deposit requirement for FCMs engaging in retail forex transactions and for RFEDs. In developing the revised Regulation 5.9, the Commission once again reviewed futures exchange margin levels, NFA’s current security deposit requirements, and comparable requirements found in other jurisdictions. Final Regulation 5.9 permits the registered futures association (“RFA”) of which the FCM or RFED is a member to determine specific security deposit levels within parameters set forth by the Commission in the regulation. The Commission has provided minimum security deposit amounts of 2 percent of the notional value for major currency pairs and 5 percent of the notional value for all other retail forex transactions. The Commission will periodically review the parameters it has set in light of market conditions and adjust them as necessary. Similarly, each RFA (i.e., NFA) will be required to designate which currencies are “major currencies,” and must review, no less frequently than annually, major currency designations and security deposit requirements, and must adjust the designations and requirements as necessary in light of changes in the volatility of currencies and other economic and



market factors. It is the Commission's view that revised Regulation 5.9 will provide a mechanism for setting security deposit levels that is both anchored in, and adaptable to, market conditions.<sup>139</sup>

The new rules also address issues of disclosure to customers:

As proposed, Regulation 5.5(e) required that the risk disclosure statement provided to every retail forex customer include disclosure of the number of non-discretionary accounts maintained by the FCM or RFED that were profitable and those that were not, during the four most recent calendar quarters. Commenters called the provision anti-competitive and doubted that measurement of profitable accounts could be done in a way that would permit comparison. Proposed Regulation 5.18(i) required that each retail forex counterparty prepare and maintain on a quarterly basis a calculation of the percentage of nondiscretionary retail forex accounts open for any period of time during the quarter that earned a profit, and the percentage of such accounts that experienced a loss. Some commenters asserted that the Commission did not provide adequate guidance or a standard methodology for calculating "winners" and "losers." Commenters stated that the proposal was ambiguous and that the reported percentages may not be comparable across the industry. In addition, commenters thought that there was too much subjectivity in determining "winners" and "losers" and that, therefore, the resulting disclosure would not be helpful for customers. Other commenters stated that by requiring retail forex firms to disclose the percentage of profitable accounts quarterly, the Commission would be unfairly singling out retail forex dealers, as this information is not required on the futures side or for broker-dealers. As noted in the Proposing Release, there are significant differences between trading futures contracts on an exchange and entering into off-exchange transactions between forex firms and retail customers. The Commission believes that as a result of the inherent conflicts embedded in the operations of the retail over-the-counter forex industry, such disclosure is necessary. To illustrate potential conflicts of interests in the off-exchange retail forex industry, the Commission in its Proposing Release pointed out that the retail forex counterparty: (i) Is the counterparty to the customer, which sets up a "zero-sum game" between the customer and the retail forex dealer; (ii) provides quotes to their customers, which may not be the best quote at the time and may not even be a competitive quote; and (iii) enters into a principal-to-principal transaction with the nondiscretionary retail forex account holder. At each stage of the transaction, the retail forex counterparty has an inherent conflict with its non-discretionary retail forex account holders. By contrast, in exchange-traded futures markets, account holders do not encounter the same level of conflicts that retail forex customers face, and, therefore, a requirement to disclose the percentage of non-discretionary retail accounts that were profitable and not profitable is appropriate in retail forex markets, while it may not be elsewhere.

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<sup>139</sup> CFTC, Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. 55410 (Sep. 10, 2010)

As a result of the industry structure and operational conflicts, the Commission believes that this disclosure is necessary to protect the non-discretionary retail forex accountholder. So while the Commission continues to believe in the value and effectiveness of such disclosures, it is adopting Regulation 5.5(e) and Regulation 5.18(l) with certain amendments, in order to address concerns regarding the implementation of the rule. As proposed, the calculation for determining whether a retail forex account was profitable or not during a quarter would be net of fees, commissions, any other expenses, trading results, customer funds deposited, and customer funds withdrawn. The regulation as adopted provides further guidance in response to commenters' concerns. The final rule clarifies that a retail forex account will be considered either "profitable" or "not profitable," with "not profitable" including accounts that break-even. The Commission is also clarifying the required time periods for which the required calculations in Regulation 5.5(e)(1) and 5.5(e)(2) must be made and records maintained and made available. Regulation 5.5(e)(1) requires that information regarding profitable and not profitable accounts for the four most recent quarters be included in disclosure documents; Regulation 5.5(e)(2) requires that similar quarterly information be maintained for five years and provided to requesting customers or potential customers. As to the 5.5(e)(1) information, once these regulations are effective, FCMs and RFEDs must provide the required information for the past four quarters. FCMs and RFEDs also must update this information going forward on a quarterly basis and disclose the most current four quarters in disclosure documents provided to potential customers. Regulation 5.5(e)(2) requires an RFED or FCM to provide to a customer or potential customer the same account information as set out in Regulation 5.5(e)(1) for the most recent five-year period during which the RFED or FCM maintained non-discretionary retail forex customer accounts, but only at the request of the customer or potential customer. The Commission intends that this requirement to keep and make available five years worth of profitable and non-profitable account information be prospective; following the adoption of these rules, FCMs and RFEDs are required to keep and maintain such data going forward on a quarterly basis until such time as they have amassed five years worth of information, at which point they will have to keep and make available the information for the five most recent years. Furthermore, prior to amassing five years of performance information, an FCM or RFED is obligated to provide, upon request by a customer or prospective customer, the historical quarterly performance information for as many quarters as the FCM or RFED has available. In addition, to provide clarity regarding the type of accounts that must be used in making the calculation of profitable and unprofitable accounts, FCMs and RFEDS must use those retail forex accounts, as defined in Regulation 5.1(i), that are non-discretionary accounts; Provided, that the retail forex account is not a proprietary account, as defined in Regulation 5.18(i)(3). The Commission believes that excluding proprietary accounts will help minimize the possibility of skewed results stemming from differing methods of calculation. The Commission is also requiring that the data be calculated on a calendar year basis for all counterparties.<sup>140</sup>

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<sup>140</sup> *Id.* at 55412-3.