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INTERNATIONAL FINANCE - FALL 2006

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INTRODUCTION

In this course we will focus on materials relating to international financial activity and

some of the legal and regulatory issues this activity raises. The course will not deal with the operations of the IMF and World Bank in any detail, although we will look at some of the IMF's initiatives.[1] The focus of the course will be on financial activities of private entities such as banks and securities firms. Materials will be available from the distribution center. It is an advantage, although not necessary, to have studied business associations, commercial law 1, IBT, securities regulation and/or banking regulation before taking this course.

One of my main aims in teaching the course is to focus on a particular type of transaction and to think about the way in which areas of the law that we tend to think of as separate in law school may be relevant to the transaction. So, for a part of the course we will be looking at standard form clauses for international syndicated loan agreements developed for the London and New York markets. In looking at these contractual clauses we will be thinking about a range of legal issues including the extent to which contracting parties can contract around fiduciary duties, and how contracts assign risks, including regulatory risks, in particular contexts. We will consider how lawyers involved in international financial transactions need to navigate around differences in the law in different jurisdictions, and we will also consider some harmonisation initiatives. We will consider some of the policy issues in financial regulation, and also consider whether and when legal harmonisation is appropriate.

THE INTERNATIONAL FINANCIAL SYSTEM

International financial activity includes many different things. Firms buy and sell different currencies; people buy debt or equity securities of 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; people[2] 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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[1] For example, the IMF's Standards and Codes Initiative. For a description, *see*, *e.g.*, http://www.imf.org/external/np/rosc/rosc.asp.

[2] Many different firms, some regulated as banks and others which are not regulated as banks, facilitate payments overseas. Examples are Paypal: http://www.paypal.com/ and Western Union: http://www.westernunion.com/info/howToSendMoneyTransfer.asp .

instruments. In all of these markets regulators worry about ensuring that the architecture of the systems and markets is sound. Regulators also worry about whether the payments system and the financial markets are being used to launder money derived from illicit sources.

Remittances.

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. More recently international financial institutions and domestic banking regulators and politicians have focused on the remittance market in which individuals (who are not typically wealthy) send money across the world. Migrant workers rely on remittance services to send money home to their families, and these remittance services may be informal services or they may be part of the formal financial system. The **Inter-American Development Bank** (IADB)[3] notes that Latin America and the Caribbean form the largest and fastest growing remittance market in the world:

LAC is both the fastest growing and highest volume remittance market in the world. This is no cause for celebration, however. It means that the Region is not producing enough employment to meet the needs of its population.
As migration patterns increase and reporting mechanisms from Central Banks improve, remittance flows for the year 2004 reached over US$45.8 billion from all parts of the world. This amount exceeded, once again, the combined flows of all Foreign Direct Investment (FDI) and net Official Development Assistance (ODA) to the Region.
Comparative IDB studies of 23 LAC countries show that remittances:
* substantially exceed that of Official Development Assistance (ODA) inflows to each country;
* equal more than 150% of the interest paid on the total LAC external debt during the past five years; and
* account for at least 10% of gross domestic product (GDP) in six countries: Haiti, Nicaragua, El Salvador, Jamaica, the Dominican Republic, and Guyana.
In 2004, Mexico was the largest recipient of remittances, at over US$16 billion, followed by Brazil then Colombia. But growth has been widespread throughout the Region: Central America and the Dominican Republic combined reach over US$10 billion; Andean countries totaled over US$7 billion; and for the first time the Haitian remittances topped US$1 billion. Individual regions such as Central America, the Caribbean, and Andean countries all report consistent increases in remittances, which

[3] The IADB (http://www.iadb.org) was established by the Organisation of American States (OAS - http://www.oas.org/) in 1959 to encourage economic and social development. It funds projects and carries out research and disseminates knowledge in the Americas.

reflect the growing integration of labor markets between LAC and the rest of the world. These amounts reflect both substantially increased volume and much improved mechanisms to accurately report the full dimensions of these flows.
There are currently an estimated 25 million LAC-born adults living outside their country of origin. Approximately 65% send money home on a regular basis, typically $100/$200/$300 a month, resulting in about 175 million separate financial transactions a year. Transaction costs to send these remittances have been cut in half over the past five years; but at 7%, they still remain too high. Almost 75% of LAC remittances are sent from the US (US$34 billion); but in recent years, Western Europe has become the fastest growing destination for LAC migrants, resulting in 12% of the market. Other large flows come from Japan to Brazil and Peru, Canada to Jamaica and Haiti; intraregional flows account for most of the rest.
At current growth rates, the projected cumulative remittances to Latin America and the Caribbean for the decade (2001-2010) will approach US$500 billion.[4]

According to the IADB, about ten per cent of the people in the world are involved in remittances:[5] although the amounts involved in individual transactions may be small, the market as a whole is significant. Remittance systems raise issues for regulators concerned about money laundering (see the excerpt from the Financial Action Task Force's (FATF) report on Money Laundering and Terrorist Financing Typologies below at page 6).

Last year, the **Governor of the Bank of Albania** discussed the significance of remittances for Albania:[6]

Let me briefly give you our (Albanian) experience with remittances and some suggestions to improve their ingress and effectiveness in the economy. During 90s, Albania experienced a massive migration movement abroad, which soon became a crucial financial source for the new market economy. According to some studies… since 1990, nearly 800,000 Albanians may have left the country either permanently or temporarily. Some more recent estimations show that the number of Albanians living abroad may have reached 1 million. This is a considerable figure for a small country like Albania with just 3 million of inhabitants. As a result, exodus phenomenon has attracted a great deal of attention in political and economic circles.

Remittances role in the economy has grown considerably over time. We can appreciate their

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[4] *See* http://www.iadb.org/mif/remittances/markets/index.cfm?language=En&parid=1

[5] *See* http://www.iadb.org/mif/remittances/markets/overview_democracy.cfm?language=En&parid=1&item1id=4

[6] Ardian Fullani, Governor of the Bank of Albania, *Key Policy Issues for Remittances in Transition Economies - a View Point from a Recipient Country*, Speech at the high level conference organised by the EBRD and sponsored by Switzerland, (Sept. 28, 2005) at http://www.bis.org/review/r051010d.pdf .

weight easier if we put them against some main economic indicators. However, before doing that I want to say a few words on data reliability of remittances. It is very difficult to carry out an accurate estimation of remittances in Albania bearing in mind that a large share does not go through formal (official) transferring channels, therefore escaping the official registration of capital flows. The Bank of Albania traces only that part of remittances that goes through the official network, which includes banks and money transfer agencies. Remittances sent unofficially such as, cash brought by emigrants or their friends during their visits to Albania, need to be estimated…

The Bank of Albania estimations indicate that total workers' remittances has reached around 1,028 million (one billion) of USD or 13.5 percent of GDP. This is main country export. Furthermore, remittances are estimated to be three times higher than foreign direct investments (FDI) inflow and its value exceeds by far official aid from abroad.

I want to concentrate a bit more on the mechanism of transfers and on the ways remittances are used. In the case of Albania, as in many other developing countries, remittances enter the country by either formal or informal means. The most recent surveys show that only 22.6 percent of emigrants prefer to use official means, whereas 77.4 percent turn to unofficial channels – in most cases by themselves.

The official network includes the commercial banks and money transfer companies, the activity of which is regulated and supervised by BoA. Money transfer companies (Western Union and Money Gram) have played a significant role in transferring remittances from the beginning of their activity in the 90s.

Their wide geographical extension throughout the country covering also many rural areas has complemented adequately the rather slow expansion of the banking sector in facilitating money transfers.

Lately, the official network has gained considerable grounds over the informal ways in terms of total transfers carried out. The volume of remittances channelled via official means in 2004 is estimated to have been around 46 percent of the total, as opposed to just 12 percent - the average for the period 1994-1996. It seems the official network has earned Albanian emigrants' trust for transferring their money. The development of the financial system in Albania it's a key factor in explaining the movement of transfers toward official means. Thus, only during 2004, there have been 30 new branches and banking agencies opened throughout the country.

Nevertheless, the unofficial flows remain still high, accounting for more than half of the total volume.

Banks and licensed agencies, despite being safer, are more expensive than the alternative unofficial means to the point of inducing many emigrants to stick to the latter means. In a comparative study of Manuel Orozco, 2003 looking at transfer costs across different countries, show that banks appear to charge less than money transfer companies. These latter tend to be costlier because of higher transfer charges and disadvantageous exchange rates they face…

Remittances inflow might have negative effects… If the recipient country remains dependant on money transfers, it will encourage further migration of labour by reducing the effectiveness of investments of domestic and foreign investors because of the unstable workforce. What's more

important, if remittances go mainly for financing imports, their impact in the development of the domestic economy drops significantly. I fear Albania is one of these cases…

Focusing on the remittance market allows us to think about cross-border financial transactions in which large numbers of consumers are actively involved throughout the world. The Governor of the Bank of Albania notes that some remitters seem to prefer to use informal rather than formal channels for remittances. Remittances therefore illustrate a distinction between formal and informal financial activity.

Concerns about money laundering and terrorist financing in particular, tend to push financial activity into formal regulated channels (so remittance service providers (RSPs) may need to be regulated as money service businesses even if they are not banks).[7] This idea that services "for the transmission of money or value" should be regulated catches informal systems such as hawala. Consider the following text:

Financial Action Task Force (FATF), Special Recommendations on Terrorist Financing (Oct. 22, 2004)[8]

"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.

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[7] *See, generally, e.g.*, http://www.msb.gov/new/index.html . For the definition of money service business see 31 CFR § 103.11uu, *available at* http://a257.g.akamaitech.net/7/257/2422/08aug20051500/edocket.access.gpo.gov/cfr_2005/julqtr/pdf/31cfr103.11.pdf. *See also* FinCen, Department of the Treasury, Guidance to Money Services Businesses on Obtaining and Maintaining Banking Services (Apr. 26, 2005) *available at* http://www.msb.gov/pdf/fincenadv04262005.pdf.

[8] http://www.fatf-gafi.org/dataoecd/8/17/34849466.pdf

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
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.[9] 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.

Informal money transmitters need to be regulated because of national rules which implement the FATF recommendations. The Governor of the Bank of Albania suggests above (at p. 5) that banks are safer but more expensive than informal remittance systems. Regulation involves compliance costs which tend to be borne by consumers of regulated services. Requiring RSPs to be regulated increases their costs of doing business. If the concern here were a concern to protect the interests of consumers of remittance services we might want to make it clear to consumers that there may be a trade-off between cost and safety. **Would that be a preferable regulatory solution?** Requiring RSPs to be regulated increases the cost of their services to consumers. The costs of preventing the use of RSPs by criminals are thus passed on to non-criminal remitters of money. In addition banks will be better able to compete with non-bank RSPs.

Note on FATF and International Standard-Setting

The FATF[10] was established in 1989:

In response to mounting concern over money laundering, the Financial Action Task Force on Money Laundering (FATF) was established by the G-7 Summit that was held in Paris in 1989. Recognising the threat posed to the banking system and to financial institutions, the G-7 Heads of State or Government and President of the European Commission convened the Task Force from the G-7 member States, the European Commission, and eight other countries.
The Task Force was given the responsibility of examining money laundering techniques and trends,

[9] This provision was added to the 2001 version in 2004.

[10] *See* http://www.fatf-gafi.org.

reviewing the action which had already been taken at a national or international level, and setting out the measures that still needed to be taken to combat money laundering. In April 1990, less than one year after its creation, the FATF issued a report containing a set of Forty Recommendations, which provide a comprehensive plan of action needed to fight against money laundering.
During 1991 and 1992, the FATF expanded its membership from the original 16 to 28 members.[11] Since then FATF has continued to examine the methods used to launder criminal proceeds and has completed two rounds of mutual evaluations of its member countries and jurisdictions. It has also updated the Forty Recommendations to reflect the changes which have occurred in money laundering and has sought to encourage other countries around the world to adopt anti-money laundering measures.[12]

Notice that this statement refers to the threat which money laundering poses to the banking system and to financial institutions. What is this threat?

The FATF is an example of an inter-governmental organisation which tries to influence the policies of states which are non-members. The FATF describes states which do not comply with its recommendations as "non-cooperative" states. As of 2006 only Myanmar is treated as being non-cooperative.[13] As a body with limited membership which sets standards for non-members the FATF illustrates the often non-democratic nature of supranational standard setting.[14] However, there are other regional groups which also focus on money-

[11] The Members are: Argentina, Australia, Austria, Belgium, Brazil, Canada, Denmark, European Commission, Finland, France, Germany, Greece, Gulf Co-operation Council, Hong Kong, China, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, Kingdom of the Netherlands, New Zealand, Norway, Portugal, Russian Federation, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States. The Gulf Co-operation Council comprises Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirate.

[12] See http://www.fatf-gafi.org/pages/0,2966,en_32250379_32236836_1_1_1_1_1,00.html .

[13] FATF, Annual Review of Non-Cooperative Countries and Territories 2005-2006 (Jun. 23, 2006) *available at* http://www.fatf-gafi.org/dataoecd/0/0/37029619.pdf. Nauru and Nigeria were previously considered to be non-cooperative.

[14] Note that the FATF states that its recommendations have been "endorsed directly by more than 150 jurisdictions around the world, as well as by the Boards of the International Monetary Fund (IMF) and the World Bank (WB) and their importance has been noted by many international bodies. For example, in July 2005, the UN Security Council in its Resolution 1617 decided that it "strongly urges all Member States to implement the comprehensive international standards embodied in the Financial Action Task Force's (FATF) Forty Recommendations on Money Laundering and the FATF Nine Special Recommendations on Terrorist Financing"." FATF Annual Report for 2005-6, 2 (Jun. 23, 2006) *available at* http://www.fatf-gafi.org/dataoecd/38/56/37041969.pdf .

laundering,[15] and the FATF is now increasing the participation of these regional groups, changing their status from observers at FATF to associate members.[16]

The IMF and the World Bank in particular have been criticised because they impose standards set by developed countries on developing countries.[17] The FATF's recommendations are among the standards (set by the developed world) which the IMF and World Bank seek to require developing countries to observe.[18] The IMF and World Bank operate a joint Financial Sector Assessment Program:

The FSAP, a joint IMF and World Bank effort introduced in May 1999, aims to increase the effectiveness of efforts to promote the soundness of financial systems in member countries. Supported by experts from a range of national agencies and standard-setting bodies, work under the program seeks to identify the strengths and vulnerabilities of a country's financial system; to determine how key sources of risk are being managed; to ascertain the sector's developmental and technical assistance needs; and to help prioritize policy responses. Detailed assessments of observance of relevant financial sector standards and codes, which give rise to Reports on Observance of Standards and Codes (ROSCs) as a by-product, are a key component of the FSAP. The FSAP also forms the basis of Financial System Stability Assessments (FSSAs), in which IMF staff address issues of relevance to IMF surveillance, including risks to macroeconomic stability stemming from the financial sector and the capacity of the sector to absorb macroeconomic shocks.[19]

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[15] For example, there is a Caribbean Financial Action Task Force (see http://www.cfatf.org/) and a Financial Action Task Force on Money Laundering in South America (Gafisud, see http://www.gafisud.org/home.htm).

[16] *See* FATF Annual Report, supra note 14 at 5.

[17] *See, e.g.*, Report of the Secretary General of the United Nations, in Larger Freedom: Towards Development, Security and Human Rights for All, ¶ 70, A/59/2005 (Mar. 21, 2005) *available at* http://www.un.org/largerfreedom/report-largerfreedom.pdf ("The Bretton Woods institutions have already taken some steps to strengthen the voice and participation of developing countries. But more significant steps are needed to overcome the widespread perception among developing countries that they are underrepresented in both bodies, which in turn tends to put their legitimacy in doubt.")

[18] The IMF has a Standards and Codes Initiative which monitors compliance by states with international standards and codes. *See*, *e.g.*, http://www.imf.org/external/np/exr/facts/sc.htm. *See also, e.g.*, Alastair Clark, *International Standards and Codes*, FINANCIAL STABILITY REVIEW 162 (Dec. 2000) *available at* http://www.bankofengland.co.uk/publications/fsr/2000/fsr09art7.pdf.

[19] Financial Sector Assessment Program (FSAP) (Last updated: August 8, 2006) at http://www.imf.org/external/np/fsap/fsap.asp

Later this semester we will focus on some specific examples of international standard-setting which affects financial markets and financial market activity. At this point it makes sense to think briefly about the reasons for international standards. Why does the FATF think that international standards for money laundering are necessary? The notion of non-cooperative territories suggests that one reason is a desire to avoid regulatory arbitrage. Regulatory arbitrage is a term which describes taking advantage of differences between different regulatory regimes. It could refer to taking advantage of differences between different domestic regulatory regimes (for example differences between regulation of brokers and investment advisers in the US) or between different national regulatory regimes. Sometimes it is not possible to engage in regulatory arbitrage. For example, if you want to send money from the US to Mexico, it probably isn't very helpful if a third country has more relaxed rules on remittances than the US or Mexico. But sometimes regulatory arbitrage is possible. If you could disguise the criminal source of your money by sending the money through a bank in Urbania, an imaginary jurisdiction that maintains bank secrecy, you might want to send the money there. But this example assumes that you would be able to live in Urbania or send the money elsewhere from Urbania (money isn't very useful if it remains in a place where you can't spend it).

International rules and standards which apply to financial activity develop because money moves around the world easily. Why should we care that Urbania does not control money laundering? (Look at the description of the Financial Sector Assessment Program at page 10).

Rationales for Financial Regulation

Although police authorities and other regulators often justify money laundering regulation on the basis that it is necessary to protect the financial markets, money laundering controls are primarily designed to prevent organised criminal activity. Other rules of financial regulation are designed to achieve other objectives: to protect the health of the financial system and to protect consumers. Some rules are primarily about protecting consumers: banks are required to make disclosures to their customers about the interest rates that will be charged on loans to the customers and about the interest rates they pay to customers on deposits. Issuers of securities are required to disclose to prospective investors in the securities the information the investor needs to decide whether to invest or not. Brokers who make investment recommendations to their clients are required to recommend only investments that are suitable for the investor.

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. So some rules of financial regulation are designed to protect the financial system itself.

Deposit insurance (which guarantees to depositors that even if the bank fails they will not lose their money (up to a specified amount)) protects consumers against loss, but also protects the financial system. People are more willing to deposit money in banks if their deposits are protected by deposit insurance, so banks can use their money to lend to others who need it. Moreover, bank runs are less likely in a banking system with deposit insurance. Without deposit insurance depositors might think that the failure of one bank is a signal that other banks may fail. If depositors in general try to withdraw their money from banks then banks in general will fail.

Deposit insurance might encourage bank managers to take more risks (moral hazard) because the customers are insulated from down side risk. So banks are subject to other rules to ensure safety and soundness and to limit the costs to the deposit insurance system. Safety and soundness of banks is also important to protect the payments system. A failing bank will not make payments to other banks and to non-financial firms. Banks that expected to receive payments which they do not receive will find that their own ability to make payments is impaired.[20] Such failures harm confidence in the financial markets. Thus, governments are convinced of the need to act to maintain investor/depositor confidence in the financial markets. Consider **William J. McDonough's comments**:

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

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[20] Anne Krueger says 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

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."[21]

Think about what this statement suggests about the appropriate role of regulators. The reference to "at least some form of regulation and official oversight" 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?

These comments relate to institutional regulation - the regulation of firms involved in the financial markets rather than to the regulation of specific transactions - for example disclosure rules and rules requiring approval of certain financial products by regulators. Note, however, that rules of institutional regulation may have an impact on how transactions are structured.

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[21] 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 chaired the Basle Committee on Banking Supervision until May 1, 2003. The current Chair is Jaime Caruana, Governor of the Bank of Spain. McDonough became Chairman of the Public Company Accounting Oversight Board on June 11, 2003 (PCAOB). The PCAOB is the body set up under the Sarbanes-Oxley Act of 2002 to deal with post-Enron issues). In 2005 he left the PCAOB and became Vice Chairman and Special Advisor to the Chairman at Merrill Lynch. *See* http://www.ml.com/index.asp?id=7695_8134_8302_63919

Consider next this excerpt from a speech by **William R White in 2002** [22]

“The growing importance of markets

Under the influence of deregulation and technical progress, the global financial system has become much bigger, faster and freer than at any period in the post World War II era.

Moreover, these markets have also become more opaque and complicated than a few decades ago. One central development is that financial intermediaries everywhere, but especially in the English-speaking countries, have lost ground to capital markets. Is this a good or bad thing? Are financial markets shock absorbers or shock creators? Without wishing to prejudge the discussions later today, I think the answer is "both", just as we now generally recognise that the old question of rules versus discretion is better phrased as how best to combine rules and discretion. A market-based world is safer in many respects than a bank-based world, not least because market disruptions do not threaten the payment system in the same way as bank failures. Nevertheless, there may still be new concerns associated with a greater reliance on markets that should (and I hope are) receiving attention. We need better trade-offs between efficiency and stability. Let me illustrate this briefly using recent experience.

Markets as shock absorbers?

Consider this last year and the number and variety of shocks to which the global economy and the financial system were subjected: stock market collapses; the failure of reforms in Japan; 11 September; the war against terror; the failure of Enron; the breakdown of the Argentine currency board and banking system; and the Middle East conflict accompanied by sharply higher oil prices. Moreover, all this came on top of a global economic downturn that could easily have gathered momentum. Indeed, many were worried, after a long period of asset price increases and credit expansion accompanied by heavy fixed investment, that we might well have a "bust" to follow the earlier "boom" of the late 1990s.

In the face of these concerns, two facts stand out. First, the macroeconomic numbers to date (essentially through 2002 Q1) do not look so bad. A global economic recovery seems underway. Second, the financial system coped marvellously well. Credit continues to flow; albeit more expensively to the less creditworthy, but that is no bad thing. Payment systems operated more or less normally, even after 11 September. And finally, there has been little contagion to other countries from either the Argentine or Turkish crises. Whether this good news will continue, of course, remains to be seen.

This latter outcome raises the question of how the financial system was able to cope so

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[22] William H White, Economic Adviser, Bank for International Settlements, Financial markets: shock absorbers or shock creators? Speech at the Fourth Geneva Conference on the World Economy, Geneva, (May 10, 2002), available at http://www.bis.org/speeches/sp020510.htm . Intermediated vs disintermediated financing :Traditionally banks acted as intermediaries between savers and borrowers, taking in money from those who had surplus funds and lending them to those who needed them; banks also engage in maturity transformation, taking in money for short periods of time, and lending for longer periods of time. Disintermediated financing is where firms raise capital directly by accessing the capital markets.

successfully. Among the possible reasons, the easing of monetary and fiscal policies in many countries was clearly of crucial importance. However, I think a further answer can be found in the changing structure of financial markets themselves. They seem to have become both more complete and more resilient. Let me give a few examples.

Markets today are more "complete" in that they offer borrowers a growing diversity of channels through which credit can be extended. Thus, in 2001, as in 1998 when the CP market also dried up, many borrowers last year fell into their banks to get finance when market conditions worsened. Moreover, the bond markets stayed open and did record volumes of fund-raising for all but the least creditworthy of borrowers. The greater diversity of corporate credit was matched by new sources of funds for households as well. Mortgage refinancing in a number of countries accelerated enormously in 2000 and 2001 (aided by GSEs in the United States), which allowed households to reprofile their lifetime consumption as they wished. As consumers spent the "cash-out" from mortgage refinancing of properties which had increased in value, they contributed materially to keeping the recovery going. Markets are also more complete in that new instruments have emerged to allow the easier transfer of risks of various sorts to those deemed best able to manage it. Credit derivatives and Special Purpose Vehicles are two good examples of the genre, and both proved legally robust in the course of the financial stresses of last year.

A case can also be made that the markets have become more "resilient" in the face of stress. One important consideration is that, with lending being less concentrated in the banking system, losses are more widely dispersed. The proverbial Belgian dentists, venture capitalists, pension funds and insurance companies have all taken a hit. Accordingly, payment systems are now less at risk than in the past. Moreover, many financial institutions are now measuring risk much more carefully. A new credit culture has clearly sprung up, prompted in part by the work of the Basel Committee on Core Principles and the New Capital Accord. Interrelated markets also share shocks, making them easier to absorb overall. Finally, information about value is now easier and cheaper both to get and to exchange. This presumably reduces counterparty risk and helps keep markets functioning even when times are stressful.

Markets as shock creators?

Listing all of these positive attributes of modern financial markets could make me sound a bit naive; in fact, there is a countervailing downside to everything I have just said.

The fact that there are more channels for providing credit may also imply that credit will become more easily available. The danger of greater access, in turn, is that firms will use it and become excessively indebted. The same is also true of households. Excessive leverage means greater exposure to such shocks as rising interest rates. Moreover, as the Merton/ Draghi/ Giavazzi paper reminds us, this exposure could easily fall back on governments in unexpected ways. Even sovereigns can get drawn into this debt trap. In retrospect, the hearty welcome given to Argentina until last year by global bond markets was most unfortunate.

As for the "completeness" brought by new instruments, many still have to be tested in a more severe turndown than the one we have experienced thus far. Moreover, and credit derivatives are a good example of some potential problems, concerns remain that originators may have underpriced

them due either to inexperience or in the context of efforts to exploit regulatory arbitrage. Finally, risk transfer capacities could lead to less "due diligence" on the part of originators, leading to more risky borrowers getting both more and cheaper credit than they would in an ideal world.

As for markets being more resilient, with risk being more widely spread, it is true that banks overall have become relatively less important and threats to the payment system less severe. Nevertheless, the growing degree of concentration both within the banking system and within individual markets could still be a cause for concern. Highly concentrated markets include the swaps market and the market for CB back-up facilities; about half of the latter is provided by JP Morgan-Chase alone. Moreover, a small number of banks now dominate the OTC derivatives market. Given these developments, it is not encouraging that the dominant financial institutions have also deteriorated significantly in credit quality. Physical concentration is also very high, with over half of all OTC and FX deals being done in London and New York. As is now well known in light of the events of 11 September, the clearing facilities in US fixed income and repos are also highly concentrated.

Risk measurement has also improved a great deal but there continue to be major shortcomings: macro shocks which simultaneously affect many companies and even whole industrial sectors need more attention; the common assumption that there is no correlation between the Probability of Default and Loss Given Default is palpably wrong; both internal and external credit ratings tend to move procyclically, as it seems to be human nature to assume that the good times will simply keep on rolling.

Interrelated markets may not diffuse shocks so much as to allow other markets to be affected in ways that would not previously have been the case. The instantaneous availability of the same cheap information by a wide range of investors may actually contribute to herding. And, in any event, how do we know that the information which drives markets is reliable? The Enron affair raised questions about conflicts of interest at every level of governance, which ultimately resulted in a very biased view of Enron's revenues, expenses and debt levels. And, more recently, similar problems pertaining to accurate accounting and information have been identified at a whole host of companies.

This, of course, raises an even broader question about governance. Why did no-one ask the right questions about appropriate supra-normal profits? If the simple answer is "because the going was good", that also tells us something about how information is processed in financial markets. Such behaviour leaves the way open for systematic overvaluation of asset prices (equities, houses, the US dollar) that could well burst, potentially creating shocks for the real economy in turn.

Conclusion

A well-functioning financial system requires well-functioning financial markets. The task currently seems to be how to identify polices that will tilt the balance to markets becoming shock absorbers rather than shock creators. However, should the financial system henceforward show more fragility than it has to date, attention might subsequently be focused on the proper balance between relying on financial intermediaries and on non-intermediated markets."

White is concerned with how to protect financial markets. What issues does he

identify? How are bank-based financial markets different from capital markets? [23] What do you think he means about the issue of rules versus discretion?

In the last few years, corporate collapses and scandals involving companies such as Enron, Tyco, Worldcom and Parmalat have prompted regulators and legislators to act to protect investor confidence.[24] The scandals and collapses raised a number of different questions about the regulation of financial markets involving questions about (1) whether US law constrained corporate officers' and directors' conduct appropriately; (2) whether financial disclosures accurately reflected 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); (3) how to make sure that financial analysts do not mislead investors as to the value of securities; and (4) the role of credit rating agencies.[25]

In 2002 **William McDonough** said:

"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. "[26]

In 2004 **Alan Greenspan** (then Chairman of the Federal Reserve Board) also discussed the

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[23] "A market-based world is safer in many respects than a bank-based world"

[24] For a graph of investor confidence levels see http://icf.som.yale.edu/Confidence.Index/ . Note that confidence has recently improved somewhat although there are peaks and troughs.

[25] 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 to proposals to regulate credit rating agencies. *See*, *e.g.*, Sec. & Exch. Comm'n, Proposed Rule, *Definition of Nationally Recognized Statistical Rating Organization*, 70 Fed. Reg. 21306 (Apr. 25, 2005) *available at* http://www.sec.gov/rules/proposed/33-8570fr.pdf **.**

[26] McDonough speech, note 21 above.

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 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.”[27]

In 2002 market participants joined regulators 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

[27] http://www.federalreserve.gov/boarddocs/speeches/2004/20040416/default.htm

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 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."[28]

More recently, although there were a number of financial scandals during 2005, and 2006 has seen developments in the options backdating scandal, there has been something of a backlash. By the time of the Securities Industry Association's (SIA) November 2005 meeting, the **SIA's President, Mark Lackritz** was saying:

"We also made good progress in the regulatory arena as some long-sought reforms were enacted, while we've drawn more attention to the unsustainable costs imposed on the industry by the blitz of new rules, regulations, and duplication.
We've urged the new SEC to adopt the strategic objectives of 1) less costly regulation; 2) more balanced supervision; and, 3) uniform national and global standards."[29]

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. **David Brown**, the Chair (in 2002) of the Ontario Securities Commission said: "To compete on the world stage, we must continually demonstrate to others that they can have confidence in our markets."[30] **Frits Bolkestein**, the EU's Internal Market Commissioner (in 2002) said:

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[28] Allen B. Morgan, Jr., SIA Chairman, *Building Investor Confidence*, Speech to the Securities Industry Association Annual Conference (Nov. 7, 2002) *available at* http://www.sia.com/speeches/html/morgan_meeting02.html . The SIA is a trade association for securities firms.

[29] http://www.sia.com/speeches/html/lackritz11-10-05.html . Note that at the same conference James P. Gorman, the SIA's 2006 Chair, stated: "...let there be no misunderstanding. SIA will never advocate a weaker, less effective regulatory structure." See http://www.sia.com/speeches/html/gorman11-11-05.html

[30] David A. Brown, Q.C., (then) Chair, Ontario Securities Commission, *Investor Confidence: A Critical Asset*, Remarks At the Corporate Reporting Awards 2002 (Dec. 5, 2002) *available at* http://www.osc.gov.on.ca/About/Speeches/sp_20021205_db_critical-asset.jsp

“The world of financial regulation has been shaken by the dramatic collapse of Enron. We have felt its effects in Europe, too. How should we react?
We must not lose our heads. After all, Enron's collapse was the result of fraudulent action. But it has prompted a timely reflection on the way in which we manage and regulate our capital markets. Getting regulation right is critical to successful economic management, and to our long-term growth prospects.”[31]

But as many in the US now want to focus on the costs of new rules, so market participants and policy makers in other parts of the world are also focusing on the costs of regulation. In the European Union (EU) now the Internal Market Commissioner, **Charlie McCreevy**, wants to make sure that businesses are 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.”[32]

Notice the reference at the end of this passage to co-operation with the US. The US' Sarbanes-Oxley Act of 2002 included a number of provisions which adversely affected foreign issuers of securities which had issued their securities in the US. As we will see later, after pressure from the EU the SEC has worked to mitigate these harsh effects, and Charlie McCreevy now talks 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

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[31] Frits Bolkestein, (then) Member of the European Commission in charge of the Internal Market and Taxation, *The EU's policy on financial integration after Enron*, speech to the American Enterprise Institute, Washington D.C., (May 29, 2002) *available at* http://www.aei.org/publications/pubID.17039,filter.all/pub_detail.asp.

[32] http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/05/793&format=HTML&aged=0&language=EN&guiLanguage=en

– 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."[33]

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 - think Eliot Spitzer), or legislatures? Does business driven regulation mean that businesses should make the rules?

Why do you think that the speakers suggest that they want to compete in terms of regulation with other jurisdictions? Is this sort of competition desirable? How does this competition fit in with the sort of negotiation that McCreevy describes?

International Finance and Trade in Financial Services

International financial activity includes a number of different types of activity. Cross-border payments are an example of international activity. We have focused on remittances so far, but individuals and businesses need to move money across borders to pay for purchases. Individuals enter into foreign exchange transactions to go on vacation abroad or as a gamble or a hedge (see infra at page). Multinational businesses may move funds between different parts of their group based in different jurisdictions.

These transactions involve a movement of funds across borders and probably also foreign exchange transactions - conversions of funds denominated in one currency to another currency.

[33] *Id.*

The foreign exchange market is the largest financial market in the world. The following excerpt is from an **SEC Release Approving the NYSE's Proposal to List CurrencyShares Trusts:**

The Exchange[34] represents that the foreign exchange market is the largest and most liquid financial market in the world. The Exchange states that, as of April 2004, the foreign exchange market experienced average daily turnover of approximately $1.88 trillion, which was a 57% increase (at current exchange rates) from 2001 daily averages. The foreign exchange market is predominantly an over-the-counter market, with no fixed location and it operates 24 hours a day, seven days a week. London, New York, and Tokyo are the principal geographic centers of the world-wide foreign exchange market, with approximately 58% of all foreign exchange business executed in the U.K., U.S. and Japan. Other, smaller markets include Singapore, Zurich, and Frankfurt. The Exchange states that there are three major kinds of transactions in the traditional foreign exchange markets: spot transactions, outright forwards and foreign exchange swaps. There also are transactions in currency options, which trade both over-the-counter and, in the U.S., on the Philadelphia Stock Exchange (''Phlx''). Currency futures are traded on a number of regulated markets, including the International Monetary Market division of the Chicago Mercantile Exchange (''CME''), the Singapore Exchange Derivatives Trading Limited (''SGX,'' formerly the Singapore International Monetary Exchange or SIMEX) and the London International Financial Futures Exchange (''LIFFE''). Over 85% of currency derivative products (swaps, options and futures) are traded over-the counter. Futures on the Australian Dollar, British Pound, Canadian Dollar, Mexico Peso, Swedish Krona, and Swiss Franc as well as options on such futures (except for the Swedish Krona) are traded on the CME (both exchange pit trading and GLOBEX trading, except for Swedish Krona futures, which trade on GLOBEX only). Standardized options on the Australian Dollar, British Pound, Canadian Dollar, and Swiss Franc trade on Phlx. Phlx also offers more customized options on certain currency pairs. According to the Exchange, these U.S. markets are the primary trading markets in the world for exchange-traded futures, options and options on futures on these currencies. Based on the Exchange's review of information supplied by major market data vendors, exchange -traded options are not traded on the Mexican Peso or the Swedish Krona.

According to the Exchange, participants in the foreign exchange market have various reasons for participating. Multinational corporations and importers need foreign currency to acquire materials or goods from abroad. Banks and multinational corporations sometimes require specific wholesale funding for their commercial loan or other foreign investment portfolios. Some participants hedge open currency exposure through off balance-sheet products.

The Exchange further represents that the primary market participants in foreign exchange are banks (including government-controlled central banks), investment banks, money managers, multinational corporations, and institutional investors. The most significant participants are the major international commercial banks that act both as brokers and as dealers. In their dealer role, these banks maintain

[34] New York Stock Exchange or NYSE.

long or short positions in a currency and seek to profit from changes in exchange rates. In their broker role, the banks handle buy and sell orders from commercial customers, such as multinational corporations. The banks earn commissions when acting as agent. They profit from the spread between the rates at which they buy and sell currency for customers when they act as principal.

In its filing, the Exchange represents that, typically, banks engage in transactions ranging from $5 million to $50 million in amount. Although banks will engage in smaller transactions, the fees that they charge have made the foreign currency markets relatively inaccessible to individual investors. Some banks allow individual investors to engage in spot trades without paying traditional commissions on the trades. Such trading is often not profitable for individual investors, however, because the banks charge the investor the spread between the bid and the ask price maintained by the bank on all purchases and sales. The overall effect of this fee structure depends on the spread maintained by the bank and the frequency with which the investor trades. Generally, this fee structure is particularly disadvantageous to active traders.

Foreign Currency Regulation. Most trading in the global over-the-counter (OTC) foreign currency markets is conducted by regulated financial institutions such as banks and broker dealers. In addition, in the U.S., the Foreign Exchange Committee of the New York Federal Reserve Bank has issued Guidelines for Foreign Exchange Trading, and central-bank sponsored committees in Japan and Singapore have published similar best practice guidelines. In the United Kingdom, the Bank of England has published the Non- Investment Products Code, which covers foreign currency trading. The Financial Markets Association, whose members include major international banking organizations, has also established best practices guidelines called the Model Code.

Participants in the U.S. OTC market for foreign currencies are generally regulated by their oversight regulators. For example, participating banks are regulated by the banking authorities. In addition, in the U.S., the Commission[35] regulates trading of options on foreign currencies on the Phlx and the Commodity Futures Trading Commission (''CFTC'') regulates trading of futures, options, and options on futures on foreign currencies on regulated futures exchanges.

The Exchange states that the Phlx and CME have authority to perform surveillance on their members' trading activities, review positions held by members and large-scale customers, and monitor the price movements of options and/or futures markets by comparing them with cash and other derivative markets' prices....

... According to the Exchange, the Trusts will be formed under the laws of the State of New York as of the date the Sponsor and the Trustee sign the Depositary Trust Agreement and the Initial Purchaser makes the initial deposit for the issuance of three Baskets. The Shares represent units of fractional undivided beneficial interest in, and ownership of, the respective Trusts. The investment objective of each Trust is for the Shares to reflect the price of the applicable foreign currency.

Each Trust's assets will consist only of foreign currency on demand deposit in a foreign currency -denominated, interest-bearing account at JPMorgan Chase, London Branch. The Trusts will not hold any derivative products. Each Share represents a proportional interest, based on the total number of

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[35] Securities and Exchange Commission (SEC).

Shares outstanding, in the applicable foreign currency owned by the specific Trust, less the estimated accrued but unpaid expenses (both asset-based and non-asset based) of such Trust. The Sponsor expects that the price of a Share will fluctuate in response to fluctuations in the price of the applicable foreign currency and that the price of a Share will reflect accumulated interest as well as the estimated accrued but unpaid expenses of the specific Trust. A Trust will terminate upon the occurrence of any of the termination events listed in the Depositary Trust Agreement and will otherwise terminate on a specified date in 2045.

The Trusts are not managed like a business corporation or an active investment vehicle. The foreign currency held by each Trust will only be sold: (1) If needed to pay Trust expenses; (2) in the event the Trust terminates and liquidates its assets; or (3) as otherwise required by law or regulation. The sale of foreign currency by the Trusts is a taxable event to Shareholders. According to the Exchange, the Trusts are not registered as investment companies under the Investment Company Act and are not required to register under such Act.

The Sponsor, on behalf of the Trusts, has requested relief from certain trading requirements of the Act. In addition, the Exchange represents that the Trusts will not be subject to the Exchange's corporate governance requirements, including the Exchange's audit committee requirements.[36]

Some of the terminology in this excerpt may be unfamiliar (try investopedia). We can discuss unclear concepts in class. The excerpt illustrates an aspect of foreign exchange which is rather different from the example of remittances. It also illustrates how foreign exchange may be changed into a security which is an investment product. One of the reasons these CurrencyShares products are being introduced is to allow investors to diversify. Investors may generally wish to diversify their investments by investing in securities and other investments based in different jurisdictions.[37] CurrencyShares allow US investors to limit the risk of decline in the value of the US dollar relative to other specific currencies. But diversification across national borders also allows investors to take account of other economic differences (which may not be fully reflected in exchange rates).

Later in the semester we will consider some of the legal issues surrounding

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[36] 71 Fed Reg 36579 (Jun. 27, 2006) available at http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-5703.pdf. See also the CurrencyShares website at http://www.currencyshares.com.

[37] Investopedia.com says that: "A risk-management technique that mixes a wide variety of investments within a portfolio. The rationale behind this technique contends that a portfolio of different kinds of investments will, on average, yield higher returns and pose a lower risk than any individual investment found within the portfolio.
Diversification strives to smooth out unsystematic risk events in a portfolio so that the positive performance of some investments will neutralize the negative performance of others. Therefore, the benefits of diversification will hold only if the securities in the portfolio are not perfectly correlated." This website is a useful resource for financial terminology: http://www.investopedia.com/

international syndicated loan agreements where financial institutions from different jurisdictions lend money to a borrower under one syndicated loan agreement. The borrower may be a large corporate or a sovereign and will wish to borrow a very large amount of money - a larger amount than any one bank is willing to lend. Some syndicated loans are domestic loans and others are international. We will focus on international loans.

Another way in which financial markets can be described as international is that some financial firms are multinational firms. For example, HSBC, which carries on business in 76 different countries, describes itself as "the world's local bank".[38] 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,[39] 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 agreement.[40] NAFTA also contains a Chapter on Financial Services[41] (and see the text in the proposed FTAA[42]). 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.

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[38] http://www.hsbc.com/.

[39] This second country is commonly referred to as the "host" country.

[40] *See*, *e.g.*, GATS, at http://www.wto.org/english/docs_e/legal_e/26-gats.pdf

[41] *See*, *e.g.*, NAFTA Chapter 14, at http://tmtm.free.fr/nafta/nafta14.htm

[42] http://www.ftaa-alca.org/FTAADraft03/ChapterXVI_e.asp

(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:

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 global financial marketplaces and strengthen European influence globally.[43]

The EU seeks to integrate financial markets by removing barriers and by agreeing on harmonised rules on financial services, but the process of harmonising the rules is a slow one. Harmonisation 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, harmonisation is even more problematic.[44] We will think about examples of regulatory harmonisation later.

The promotion of free trade in financial services is one reason for promoting harmonisation 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.

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[43] *See, e.g.*, EU Commission, WHITE PAPER: FINANCIAL SERVICES POLICY 2005-2010 (Dec. 5, 2005) *available at* http://europa.eu.int/comm/internal_market/finances/docs/white_paper/white_paper_en.pdf

[44] *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).

Harmonisation of regulation is an alternative to extraterritorial application of rules.

Regulatory harmonisation also limits the ability of firms to escape regulation by moving their activities into another jurisdiction (regulatory arbitrage). As mentioned above, international harmonisation 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 (see above at p.6) (FATF 40+ 8), to the list of areas and associated standards and codes that are incorporated into the operational work of the Fund".[45] This means that the IMF will monitor the application of these recommendations as it monitors other aspects of the countries whose affairs it reviews.

Legal harmonisation 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 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." [46]

Crises in developing markets during the 1990s led to general concern about the "International Financial Architecture",[47] and to the setting up of the Financial Stability

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[45] 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 http://www1.oecd.org/fatf/

[46] 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) *available at* http://europa.eu.int/eur-lex/pri/en/oj/dat/2000/l_160/l_16020000630en00010018.pdf . UNCITRAL has developed a Model Law on Cross-Border Insolvency, *available 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: Eritrea, Japan (2000), Mexico (2000), Poland, Romania (2003), South Africa (2000), within Serbia and Montenegro, Montenegro (2002), British Virgin Islands, overseas territory of the United Kingdom of Great Britain and Northern Ireland (2005), and United States of America (2005)." *See* http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html

[47] *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

Institute.[48] A growing body of literature connects the level of development of a country's securities markets with its economic health. It is argued that countries with strong securities markets tend to have high levels of economic growth.[49] Thus it is 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.

These different reasons for legal and regulatory harmonisation have been described as follows:

> The combination of highly integrated capital markets worldwide and country-based jurisdictions is probably the most notable feature of today's international financial environment. This combination raises three concerns. First, policy-relevant frictions might arise from the diversity (and in some case incompatibility) of national legal systems. Second, there might be a concrete risk of legal arbitrage among jurisdictions, with a loss of predictability in the application of norms and thereby in the actual balance between the different goals that each legal framework tries to reconcile. Third, as a result of financial integration negative externalities (in the form of spillover and contagion effects) might be the consequence of deficiencies or gaps in the legal systems of certain jurisdictions (emerging market countries and offshore centres being obvious examples).[50]

Critics of harmonisation argue that legal harmonisation has risks:

> I am also concerned that the effort to homogenize capital rules across the world may do serious

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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.")

[48] http://www.bis.org/fsi/index.htm

[49] *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 . *See also*, *e.g.*, the World Bank's pages on the Legal Institutions of a Market Economy at http://www1.worldbank.org/publicsector/legal/ , and on the Financial Sector at http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTFINANCIALSECTOR/0,,menuPK:282890~pagePK:149018~piPK:149093~theSitePK:282885,00.html

[50] Contact Group Report, note 46 above, at 1.

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."[51]

Some commentators argue that rather than emphasising harmonisation 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.

Do you think that international harmonisation of financial regulation is a good idea? What do you think might be the advantages and disadvantages of such harmonisation?

Consumer Protection and Remittance Services

The costs of making overseas remittances may be steep. For example, to send $100 from Florida to Haiti via Western Union's Money in Minutes service costs $20 (it costs $18.99 to send the same amount to Mexico (although at the beginning of 2006 the cost to Mexico was $14.99). Sending larger amounts may be cheaper (businesses which regularly make cross-border payments may negotiate special terms with their banks).

The consumers who send remittances are not typically very wealthy or highly educated or sophisticated about financial transactions. This raises questions about how remittance services might be regulated.[52] Because remittances are sent from one country to another there are two different sets of rules which may affect the costs of sending the money. For example, if a country prohibits credit unions but not banks from receiving remittances,

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[51] 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 at* http://www.occ.treas.gov/ftp/release/2003-99a.pdf

[52] The US House Committee on Financial Services held hearings in 2003 on the issue of whether remittance services should be regulated. *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).

credit unions in that country may be forced to become banks.[53] 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.

In March 2006 the Bank for International Settlements (BIS) Committee on Payment and Settlement Systems and the World Bank published a **Consultative Paper on General Principles for International Remittance Services**.[54] The CPSS and World Bank identified 5 key issues relating to remittance services:

...five possible features of the market for remittances.. can lead to inefficiencies in the way remittance services are provided. Such market inefficiencies can mean that the price of remittance services is higher than would otherwise be the case and/or that the services offered are of lower quality. The five features are:
• a lack of transparency in the market and of understanding by users;
• weaknesses in the infrastructure that is used to provide remittance services;[55]
• the possibility of adverse effects from poor or disproportionate regulation or a weak legal framework;
• lack of competitive market conditions;[56] and
• risk.[57]

These factors combine issues that relate to consumer protection as such

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[53] *See*, *e.g.*, *id.*

[54] See http://www.bis.org/publ/cpss73.pdf (there is a link in the information sources page on the class weblog).

[55] These include: “creating a network of access points; weaknesses in the financial infrastructure in receiving countries; and the often relatively under-developed state of cross-border retail payment arrangements.” *Id.* at 10.

[56] These include situations “where an RSP allows its agents or other RSPs to offer its remittance service only on condition that they do not offer any other remittance service” and limitations on access to payment systems (if only banks can be memebrs of payment systems other types of firm are excluded). *Id.* at 13.

[57] *Id.* at 8.

(transparency, lack of competition, weak legal framework) and issues that relate to the health of the financial system (infrastructure, weak legal framework). As to **transparency**, the Consultative paper suggests that the total costs of the transaction may not always be apparent to customers and that they may not have full information about the speed of the transaction:[58]

38. A remittance transfer will usually involve a foreign exchange transaction – typically conversion from the currency of the sending country to the currency of the receiving country. To know the total price of the transfer, the sender needs to know the exchange rate that will be used since different RSPs are likely to use different exchange rates, which vary from day to day. In practice, RSPs typically charge senders an exchange rate that includes a margin above the current interbank or wholesale market rate. In part, the margin may reflect uncertainty the RSP faces. Many RSPs trade only relatively small amounts of foreign currency and have to ask a bank or other foreign exchange intermediary to obtain the currency on their behalf... Therefore the RSP may not know the exchange rate it will face when it forwards the funds, and a margin gives it some protection if exchange rates move adversely. However, this protection could come from an explicit fee rather than a margin. So the margin is essentially another form of fee – a fee which is not easily visible to the sender (who is unlikely to know what the current interbank market rate is).
39. The ability of an RSP to be transparent about any disbursing RSP's fee depends on the type of service (ie whether it is unilateral, franchised, negotiated or open). An advantage of franchised and negotiated services is that it should be possible for the capturing RSP to receive information in advance on the fee that the disbursing RSP will charge to the receiver. This information can then be provided to the sender so that they are aware of the total price. The same is of course possible with unilateral services (where the capturing and disbursing RSPs are the same). However, in an open service transparency about the disbursing RSP's fee is generally not possible because the RSP has no relationship with the disbursing agent, and thus no way of knowing what the disbursing agent will charge. (Indeed, in an open service this is why the disbursing agent usually needs to charge the receiver a fee – otherwise it would receive no income for the service it provides.)
40. As with the disbursing RSP's fee, the speed of the transaction is also more likely to be known in a unilateral, franchised or negotiated service than in an open service. Speed depends on the speed of both messaging and settlement (or whether there is liquidity provision to the disbursing agent so that payout can take place before settlement is complete). The actual time the settlement process takes depends on how fast each of the intermediate steps is and, in negotiated, franchised and unilateral services this should either be standardised and known (eg that a domestic payment in the receiving country always takes one day) or negotiated (eg that the RSP in the receiving country will process the payment within one day of receiving it). Moreover, to the extent that there is some uncertainty about the time (eg because of uncertainty about how fast banks will process payment instructions), the RSP can still offer a fixed transaction time provided that information flows separately from settlement and

[58] The excerpts refer to RSPs (remittance service providers). Footnotes are omitted.

that the speed of the information flow is known (eg instantaneous if a computer link is used): the RSP can then agree with the disbursing agent that payment to the receiver will be made when the information is received or a fixed time afterwards and, if necessary, that liquidity will be made available to the agent to enable this to happen.

41. In an open service there is no direct contact or negotiation between the RSPs involved and so the capturing RSP has limited control over the speed of the process. Indeed, the service is likely to be relatively slow. Because of the lack of a relationship with the capturing RSP, information about the remittance travels only with the funds, so the disbursing agent usually cannot pay out before it has been paid. Speed is thus determined by how fast the settlement process is (which is likely to be at least several days under most normal banking processes). However, set against this loss of speed, and the lack of transparency mentioned above, open services have the significant advantage of almost unlimited global coverage. For example, many banks and other deposit takers allow their customers to transfer money to virtually any other similar institution anywhere in the world. This coverage is likely to be particularly valuable for remittance corridors that are small and thus where it may be uneconomic to provide negotiated, franchised or unilateral remittance services.

42. Even if individual RSPs are fully transparent, it may not be easy for end users to compare the price of different services. This is partly because market exchange rates constantly change, different margins may be applied to different currency pairs (eg to reflect differences in their volatility) with these margins changing from time to time (eg as volatility changes), and the margins may be added to different "reference" rates (eg open market rates at different times of the day). Thus the cheapest RSP on a given day in a given currency pair may not be the cheapest on a different day or in a different currency pair. Of course prices in all consumer markets differ across products and change from time to time (although not usually daily). But a further important complication for remittance transfers is that the cheapest RSP in terms of the exchange rate may not be the cheapest in terms of the fee charged, and for most people the calculation to work out which is cheapest overall is difficult. by "access problems" due largely to their social and economic status. For example, low-income migrants in a foreign country may have difficulties with the local language that make it hard to understand remittance services, difficulties in proving their creditworthiness or providing appropriate identification to access certain services (if they lack the relevant documents), and lack the time and financial literacy to identify and compare alternative remittance services. This may significantly limit the number of services they can access, even if the market is potentially competitive.

44. At the same time, RSPs themselves may lack information about the market. Knowledge about remittances is increasing, but many potential RSPs may still be unaware of the size of the market in key corridors. They may also see payment services in general as being primarily a base from which other more profitable services can be sold, and remittances as therefore being unattractive because senders typically have relatively low income. Senders may therefore find that some services (such as those based on bank accounts) are not readily available to them.

45. Transparency is likely to have some cost. As well as the direct costs of providing information, there may be a cost attached to achieving the certainty about the service that enables the RSP to be transparent. For example, as discussed above, in a negotiated service a fixed transaction time may

be possible only if liquidity is made available to the disbursing agent so that funds can be paid to the receiver at a fixed time even if settlement is not complete by then, and providing such liquidity has a cost. Any costs are likely to be passed on to the consumer. But this disadvantage is likely to be outweighed by the significant advantage, namely that transparency is likely to make competition more effective and drive down prices as consumers compare the true total price of different services.

The Consultative Document also addresses issues relating to the legal regime within which remittances are provided:

54. The remittance industry, like any other, is likely to flourish best when the general legal framework in which it operates is sound, predictable, non-discriminatory and proportionate. Particularly important here is likely to be the enforceability of contracts, especially when the parties to the contract are in different jurisdictions. This is a significant issue, largely outside the scope of this report, but one that is worth emphasising because in a number of countries such a framework does not yet exist.
55. Also important is any specific regulation applied to remittances. The term 'regulation' is used here to refer to any intervention in the market by the authorities in the form of legally binding laws and requirements. However, it is worth noting that the issues discussed below concerning regulation may also apply to non-legally binding guidance, best practices, principles, or recommendations to the extent that RSPs come under pressure from the authorities or the market to conform to such policies. Regulation of remittances may exist for various reasons. However, as with all regulation, there is the possibility that it is badly designed, with unintended side effects, or that it is disproportionate to the scale of the problem it is designed to tackle, or that it continues to be applied even when it is no longer useful.
and terrorist financing. Recommendations on how this should be done have been set out by the Financial Action Task Force on Money Laundering.
57. However, remittance services may also be regulated for other reasons, which are likely to vary from country to country. Here there is less of a consensus on what needs to be done, and although such regulation may often be useful, in some cases regulations may have an adverse impact on the market. For example, although it may be useful for the authorities in both sending and receiving countries to monitor RSPs in order to understand the market and determine what regulation, if any, is necessary, data may sometimes be collected that is never used. Similarly, fees for licensing or registering RSPs may be too high and used mainly as a means of raising additional government revenue. And since RSPs are typically not deposit takers, provide only a minority of a sender's overall payment needs, and (at least in the case of services that transfer the funds more or less immediately to the receiver) hold the funds for only a short time, then to apply heavy prudential requirements to RSPs may be disproportionate.
58. Regulating remittances solely by type of entity may make regulation less effective (by creating loopholes that are exploited for illegal activities) and distort markets (by enabling some RSPs to inappropriately avoid the costs of regulation and thus offer artificially cheaper services). At the same time, regulation should not aim to create a level playing field between different RSPs per se, but

rather a level playing field between equivalent remittance services. Regulation is aimed at preventing or correcting market failures in the provision of the services, not the institutional structures used to deliver them. Some RSPs also offer other services as well as remittances (eg they may take deposits and give credit) and may be subject to more intensive regulation because of these services; depending on how they set their prices, they may therefore be more expensive than an RSP that only offers remittance services. However, where this occurs, it is not an unfair distortion but the result of their method of allocating costs when setting prices or of a market disadvantage of offering remittance services bundled with other services.

The Consultative Paper suggests that: "International remittance services should be safe and efficient. To this end, the markets for the services should be contestable, transparent, accessible and sound."[59]

On the legal regime which should apply to remittances the document states:

Remittance services should be supported by a sound, predictable, non-discriminatory and proportionate legal and regulatory framework in relevant jurisdictions.
80. The legal and regulatory framework includes both the general legal infrastructure (such as the law relating to contracts, payments, securities, banking, debtor/creditor relationships and insolvency) and any specific statutes, case law, regulations or contracts (for example, payment system rules) relevant to remittances. ...[T]he points covered by this principle may also be relevant to non-legally binding policies (such as recommendations) issued by the authorities.
81. This principle does not call for the establishment of a specific legal regime for remittances. A country's existing laws and regulations may already address the requirements of the principles or may be capable of being modified to do so. In particular, the provision of remittance services is likely to be helped by a well-founded legal framework governing domestic payments.
The legal and regulatory framework should be sound, predictable, non-discriminatory and proportionate
82. To be well-founded, the legal and regulatory framework should be sound, predictable, non-discriminatory and proportionate. A sound framework that is well understood helps minimise the risks faced by both RSPs and their customers. A predictable framework is one in which it is clear which laws and regulations are relevant, where they do not change with excessive frequency and where they are enforced by the authorities, including the courts, in a consistent manner. Predictability is a key component in creating a climate that favours private sector investment. This is crucial in order to increase competition in, and to improve the quality of, remittance services.
83. Non-discriminatory refers to the legal and regulatory framework being equally applicable to different types of RSPs insofar as they are providing equivalent services, ie independently of the

[59] *Id.* at 14.

nature of the provider's other lines of business. This helps to promote a level playing field between different RSPs that encourages competition on a fair and equitable basis. Because remittance services are provided by many different types of service providers, a functional rather than institutional framework may be desirable to minimise different treatment of service providers offering similar services. However, often this may be impractical: many countries already have different bodies of law and regulations applying to different types of RSPs and changing this would be difficult. For example, bank RSPs and non-bank RSPs may be governed by different, well-established legal and regulatory frameworks. Where this is the case, the underlying principle can be met instead by ensuring that equivalent rights and obligations exist regardless of which body of law applies to an institution. For example, the know your customer requirements for the purpose of remittances should be the same for banks and for non-bank RSPs even if they are governed by separate regulations.

84. Proportionate means that the legal and regulatory framework for remittances should not be overly restrictive and burdensome relative to the possible issues it is designed to tackle or the number and value of transfers involved.

Multiple legal and regulatory frameworks

85. A remittance involves at least two jurisdictions, the sending and the receiving countries. Where the RSP or its agents operate in third countries, other jurisdictions may also be involved. Laws and regulations in relevant jurisdictions need to be well-founded for the legal and regulatory framework governing the provision of remittance services to be fully effective. The authorities of a given country can, of course, only have a direct influence on the framework in their own country. Nevertheless, particularly if they are aware of a significant legal issue in another country in an important bilateral corridor, they may want to work with the authorities of the other country to try to resolve the issue.

86. To achieve a well-founded legal and regulatory framework internationally, harmonisation of legal and regulatory structures may sound appealing. However, different jurisdictions have different priorities and can take different legal approaches. As such, universal harmonisation of laws and regulations is extremely difficult to achieve and may be of no additional benefit if the laws and regulations of different countries are aimed at the same public policy objectives.

The content of the regulatory framework

87. Considering the way in which remittances in a country are regulated, an important aspect of any regulatory framework is that it should meet internationally agreed standards. Particularly relevant in this context are regulations implementing anti-money laundering and combating the financing of terrorism (AML/CFT) recommendations such as the Financial Action Task Force's recommendations and special recommendations. All RSPs should comply with the AML/CFT regulations applicable to them.

88. Some of the other areas that, in some countries, may be covered by regulation include transparency of conditions applicable to end users (eg prices and execution times), customer protection measures (eg dispute resolution mechanisms) and the adoption of adequate measures to mitigate risks faced by RSPs (eg legal, credit, liquidity and operational risks). To meet the FATF AML/CFT recommendations, RSPs have to be licensed or registered; it is up to the relevant authorities to decide whether it is useful to also use this licensing or registration process for

implementing any other areas covered by regulation.
89. It is important that any regulation balances the benefits of increased safety and soundness against the potential costs in lost efficiency, competition, and innovation. Complying with regulations can often be costly and therefore may drive up remittance prices. Regulations can also be a barrier to entry and thus restrict competition. Authorities may also want to avoid designing regulation around specific payment instruments or distribution channels, since technologies deployed in the provision of remittances change rapidly and as far as possible such innovations should be accommodated easily with low cost and without changing regulations.
90. The remittance industry should be consulted when designing the regulation of remittances to help ensure that the regulation is proportionate and effective. In some cases, the industry itself may develop codes of conduct or self-regulatory regimes that are as effective, or possibly more effective (because of lower compliance costs and greater flexibility) than formal regulation. However, the effectiveness of self-regulation is likely to depend on many factors, including how developed the remittance industry is.[60]

Note the reference in para. 90 to the idea of self-regulation (and see p. 21 above).

Risk and finance

The brief statement by William McDonough (above at p. 13) referred to the idea that risk and risk management were important for financial firms. We will see during the course that regulators separate out different types of risk associated with financial transactions and the carrying on of financial business and expect financial firms to address the different risks with different techniques (NB. see the discussion of credit risk at p.43 below). The Consultative Paper on Remittances we have been looking at also addresses the issue of risk:

62. RSPs may face financial, legal, operational, fraud, and reputational risks. The relatively small values involved in remittance transfers mean that it is unlikely that there will be systemic risk. Remittances are therefore unlikely to cause stability problems for financial institutions. However, other financial risks can arise with remittances, particularly in markets that are not very transparent, where the legal basis is weak, or where the financial system is not well developed.
63. For senders (and receivers), the potential risk when making a remittance is that of losing the funds while they are in transit (eg due to the bankruptcy or error of the RSP or one of the intermediaries or because of fraud). The extent of the risk depends on the nature of the contract between the sender and the RSP and where the problem occurs. With franchised or unilateral networks, then, unless the problem is the bankruptcy of the RSP itself, it is likely that the RSP will

[60] Consultative document at 17-19.

bear any risk: the contract between the sender and the RSP is likely to be to get the funds to the disbursing agent and it will be the RSP's responsibility if this fails to happen. With negotiated and open networks, it may be less clear cut: at some point in the transaction, responsibility may transfer from capturing to disbursing RSP.
64. For the RSP itself, the extent of the risk of loss of funds in transit depends on the nature of the remittance service. For example, the extent and duration of its exposure to the possibility of failure by the disbursing agent depends in part on whether or not it has provided liquidity to the agent. As well as the direct credit or liquidity risk of loss in transit, or the operational risk of a failure on its own part, the RSP also faces reputational risk unless it has adequate arrangements to ensure receivers get their funds on time even when there has been a loss in transit. Reputational risk could also arise from misuse of the service for illegal purposes such as money laundering. Lack of sound governance and risk management practices on the part of RSPs can exacerbate such problems.

Notice how this excerpt distinguishes between different types of risk. What do you think the term “legal risk” means?

Distinguishing Between Financial Activity and Non-financial Activity

Financial firms such as banks and securities firms and insurance companies are subject to regulation that does not apply to non-financial firms (and the rules differ according to the financial activity the firm is engaged in). But it can be difficult to distinguish between financial and non-financial activity. Should we treat trading in non-financial assets that are easily saleable (liquid) as being like making payments of money, or not?

In previous versions of these materials I included a long excerpt from a complaint[61] by the EU Commission in litigation which the EU tried to pursue in federal court in the US in which it accused RJR Nabisco of money laundering (and non-payment of customs duties). In 2005 the 2nd. Circuit held that the revenue rule barred such a lawsuit by a foreign sovereign.[62]

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[61] The complaint is at http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/tobacco/ectobaccocmplt.pdf (NB it is very long and you do not need to read it).

[62] *European Community* v *RJR Nabisco*, 424 F.3d 175 (2005). The 2nd Circuit stated: “the revenue rule is designed to address two concerns: first, that policy complications and embarassment may follow when one nation's courts analyze the validity of another nation's tax laws; and second, that the executive branch, not the judicial branch, should decide when our nation will aid others in enforcing their tax laws... These twin concerns for sovereignty and separation of powers are important to the revenue rule analysis, because they imply certain exceptions to the rule. In particular, when the executive branch affirmatively consents to litigation (e.g., by initiating it in a criminal prosecution), there is little reason to worry about infringing on the executive's sphere of decision-making, and the rule will not be applied.”

But the EU argued that transactions in cigarettes were functionally equivalent to payments of money. Here is a short excerpt:

32. There are numerous important steps in any money laundering cycle. "Dirty" money of necessity moves in a way that is specifically designed to conceal or disguise its nature, source, ownership, and/or control. Successful "layering" of "dirty" transactions will often involve intermediaries, like money brokers, as a matter of necessity and convenience. These "money brokers" play an important role in the laundering conspiracy. They serve to isolate relevant coconspirators from the overt criminal acts, and because of that they are often referred to by law-enforcement agencies as "cut outs." The "cut out" is purposefully inserted into the transaction to create a layer of activity between the overt criminal actors and those receiving the laundered proceeds or profits of the criminal scheme. The "cut out's" role is to shield the true participants in the conspiracy from discovery.
33. In this money-laundering conspiracy, the RJR Defendants' role will often be masked by the activities of the "cut outs." ... The "cut-out" strategy is also relevant to the sales and marketing end of the international cigarette export cycle. When a cigarette manufacturer intentionally sells its products into criminal distribution channels via carefully selected wholesalers, so that it can deny responsibility for "where the customer sells the product," the manufacturer is using that wholesaler as a "cut out" to insulate itself from the overt acts involved in the sale of cigarettes as a means of supporting the money- laundering cycle.
34. The cut-out strategy works for the benefit of the manufacturers looking to increase market share and for those merchants looking to conceal their involvement in legal or illegal business activity. Overall, this process develops into the creation of an unfair business strategy for the manufacturer that increases its market share by creating a competitive disadvantage. By operating outside the legal framework for fair business operations, the manufacturer creates an unfair advantage for itself as against its competitors in virtually all aspects of business activity, including profit margins, financing terms, price structures, shipping, storage, advertising, regulation (e.g., in the case of cigarettes, health warnings), reporting obligations, and other aspects of business strategy. The resulting "competitive disadvantage" is particularly onerous to domestic companies that must comply with an array of regulations ranging from the sourcing of raw materials to laws governing treatment of their employees. Consequently, domestic manufacturers in The European Community (both state owned and privately owned) are particularly harmed by the cut-out strategy...

The FATF has now begun to focus on **Trade Based Money Laundering**:

The study concludes that trade-based money laundering represents an important channel of criminal activity and, given the growth of world trade, an increasingly important money laundering and terrorist financing vulnerability. Moreover, as the standards applied to other money laundering techniques become increasingly effective, the use of trade-based money laundering can be expected to become increasingly attractive.
Looking ahead there are a number of practical steps that can be taken to improve the capacity of

national authorities to address the threat of trade-based money laundering. Among these are the need for a stronger focus on training programs to better identify trade-based money laundering techniques, the need for more effective information sharing among competent authorities at the national level, and greater recourse to memoranda of understanding and mutual assistance agreements to strengthen international cooperation...

trade-based money laundering is defined as the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimise their illicit origin. In practice, this can be achieved through the misrepresentation of the price, quantity or quality of imports or exports.

In many cases, this can also involve abuse of the financial system through fraudulent transactions involving a range of money transmission instruments, such as wire transfers. The basic techniques of trade-based money laundering include:

• over- and under-invoicing of goods and services;
• multiple invoicing of goods and services;
• over- and under-shipments of goods and services; and
• falsely described goods and services...

Money laundering through the over- and under-invoicing of goods and services, which is one of the oldest methods of fraudulently transferring value across borders, remains a common practice today. The key element of this technique is the misrepresentation of the price of the good or service in order to transfer additional value between the importer and exporter.

By invoicing the good or service at a price below the “fair market” price, the exporter is able to transfer value to the importer, as the payment for the good or service will be lower than the value that the importer receives when it is sold on the open market.

Alternatively, by invoicing the good or service at a price above the fair market price, the exporter is able to receive value from the importer, as the payment for the good or service is higher than the value that the importer will receive when it is sold on the open market...

Another technique used to launder funds involves issuing more than one invoice for the same international trade transaction. By invoicing the same good or service more than once, a money launderer or terrorist financier is able to justify multiple payments for the same shipment of goods or delivery of services. Employing a number of different financial institutions to make these additional payments can further increase the level of complexity surrounding such transactions.

In addition, even if a case of multiple payments relating to the same shipment of goods or delivery of services is detected, there are a number of legitimate explanations for such situations including the amendment of payment terms, corrections to previous payment instructions or the payment of late fees. Unlike over- and under-invoicing, it should be noted that there is no need for the exporter or importer to misrepresent the price of the good or service on the commercial invoice...

In addition to manipulating export and import prices, a money launderer can overstate or understate the quantity of goods being shipped or services being provided. In the extreme, an exporter may not ship any goods at all, but simply collude with an importer to ensure that all shipping and customs documents associated with this so called “phantom shipment” are routinely processed. Banks and

other financial institutions may unknowingly be involved in the provision of trade financing for these phantom shipments...[63]

An Annex to the document describes the Role of Financial Institutions in the Settlement of Trade Transactions:

Financial institutions can play three roles in the settlement of international trade transactions, namely, money transmission, provision of finance, and lending the institution's name to the transaction. Below is a simple description of these roles.
Money transmission – is the transfer of funds between parties associated with the trade transaction. (e.g. a wire transfer).
Provision of finance – is the provision of credit to support the trade transaction. In these situations, as a standard practice, the financial institution conducts standard credit checks against the customer. In addition, the financial institution may conduct a check against the underlying transaction.
Lending the financial institution's name to the transaction – occurs in two situations: (1) where the financial institution undertakes to make payment subject to certain conditions (e.g. a letter of credit), and (2) where the financial institution undertakes to make payment if the buyer defaults (e.g. a guarantee).
In addition to monitoring in accordance with domestic anti-money laundering and counter-terrorist financing regulations, the levels of scrutiny and information available on the underlying transaction will depend upon the bank's exposure to credit and reputational risk associated with the provision of finance and lending of the bank's name to the transaction. For example, because an institution's risk exposure when conducting a money transmission is low, it is unlikely that the institution will closely scrutinise or even see the documents supporting the transaction (e.g. bills of lading or invoices).[64]

Is it reasonable to expect banks to monitor the characteristics of their clients' trade transactions ?

Hedging and Speculation

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.[65] Householders take out insurance policies to protect their investment in their

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[63] FATF, Trade Based Money Laundering (Jun. 23 2006) *available at* http://www.fatf-gafi.org/dataoecd/60/25/37038272.pdf

[64] *Id.* at 27.

[65] See below at page 45 ff for some material on derivatives.

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."[66]

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 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,

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[66] 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

and derivatives transactions are regulated,[67] 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 are as a result subject to less regulation.[68]

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 favourable 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 derivatives markets illustrate the tendency of the financial markets to become increasingly complex. 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 have recently become particularly concerned about the risks associated with credit derivatives. 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. If the parties to credit derivatives transactions do not understand the risks associated with those transactions, such transactions may threaten

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[67] 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. *See*, *e.g.*, http://www.cftc.gov/sfp/sfpbackground.htm)

[68] Banks which enter into swap contracts need to have regulatory capital in respect of risks associated with these contracts. We will look at bank capital requirements later.

financial stability.[69] Credit derivatives may have the effect of transferring risk away from regulated entities such as banks to less regulated entities. Regulators may be concerned about how to deal with newer and complex financial products such as credit derivatives in assessing risk. For example, the UK's Pension Protection Fund, which is responsible for pricing the risk that pension funds in the UK are underfunded, and which will impose 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 (a type of credit derivative) for the 2006/7 levy:

"The Board has also considered the inclusion of credit default swaps, but has decided not to recognise 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."[70]

The International Swaps and Derivatives Association (ISDA) has challenged the assertion that there are 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.[71]

In February 2006 the Board suggested that it had listened:

Several consultation responses specifically noted the Board's intention not to recognise Credit Default Swaps (CDS) within the 2006/07 risk based levy calculation. As set out in the December consultation document, the Board has decided not to recognise CDS in the levy calculation until such time as standardised documentation and procedures can be developed to reflect the specific and more

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[69] *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

[70] Pension Protection Fund, THE PENSION PROTECTION LEVY CONSULTATION DOCUMENT, para. 2.3.27 (Dec. 2005) *available at* http://www.pensionprotectionfund.org.uk/rbl_dec_05v4.pdf .

[71] See http://www.isda.org/whatsnew/pdf/PrelimResp.pdf

complex mechanics of their operation.
The Board has particularly welcomed the helpful responses which have discussed in detail the ways in which standardised documentation could be adapted to enable recognition of CDS without disproportionately increasing the administrative burden on the Pension Protection Fund, and the cost to levy payers. The Board will be working closely with key market stakeholders to develop their proposals in this area during 2006 with a view to including CDS in the risk based levy calculation for future levy years.[72]

This example illustrates a regulator working out how to deal with new financial instruments, but it is also an examople of how industry bodies try to affect regulation. 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 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.[73]

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 have agreed to co-operate in relation to the regulation of derivatives.[74]

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?

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[72] Pension Protection Fund, THE RESPONSE TO THE SECOND PENSION PROTECTION LEVY CONSULTATION, paras. 2.2.10-2.2.11 (Feb. 2006) *available at* http://www.pensionprotectionfund.org.uk/february_consultation_response.pdf.

[73] I'm working on issues relating to financial trade associations and how they try to affect financial regulation. I have posted a draft of a paper on multi-level financial regulation on the class weblog at http://intfin06.umlaw.net/wp-content/uploads/2006/08/multilevelhague.002.pdf in case you are interested.

[74] *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

The next two readings address some of the issues we have already met and raise some new ones.

Excerpt from CME Prospectus for Sale of Class A Common Stock[75]

This excerpt describes the Chicago Mercantile Exchange's (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 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,

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[75] At pp 65-68. The document is dated (Dec. 6, 2002) and is *available at* http://www.sec.gov/Archives/edgar/data/1156375/000104746902006277/a2095862zex-99_1.htm

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 BourseSBF 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 ATSs.

• 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.

• ATSs. Advances in electronic trading technology have also led to the emergence of ATSs. 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. ATSs 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."

Exchange transactions need to be cleared and settled after they are agreed. Market participants have different views about whether it is a good idea for clearing and settlement firms to be vertically integrated with exchanges, or not. The CME states:

"Some of our largest clearing firms, which are significant customers and intermediaries in our products, have increasingly stressed the importance to them of centralizing clearing of futures contracts and options on futures in order to maximize the efficient use of their capital, exercise greater control over their value at risk and extract greater operating leverage from clearing activities. Many clearing firms have expressed the view that clearing firms should control the governance of clearing houses or that clearing houses should be operated as utilities rather than as for-profit enterprises. Some of these firms, along with the Futures Industry Association, are attempting to cause legislative or regulatory changes to be adopted that would facilitate mechanisms or policies that allow market participants to transfer positions from an exchange-owned clearing house to a clearing house owned and controlled by clearing firms. Our strategic business plan is to operate a vertically integrated transaction execution and clearing and settlement business. If these legislative or regulatory changes are adopted, our strategy and business plan may lead clearing firms to establish, or seek to use, alternative clearing houses for clearing positions established on our exchange."[76]

What is the point of this contrast between clearing houses "operated as utilities" and

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[76] Note 74 above, at 15.

clearing houses operated "as for-profit enterprises" ? Compare this description of the issue:

"We now have demutualized, for-profit exchanges. The FIA has not opposed demutualization - we understand the benefits of having a more flexible and faster-moving governance structure and access to capital markets. And we certainly are not opposed to profits. But we all have to remember that a liquid futures contract, cleared at a captive clearinghouse, is one of the strongest de facto monopolies on earth. And we need to think about how for profit companies might use that market power."[77]

Regulation has implications for competition: licensing requirements operate as barriers to entry. We will think about some of these issues later.

Exchanges (not just derivatives exchanges but also securities exchanges) often exercise power over financial firms as self-regulatory organisations (SROs). Changes in the ownership structure of exchanges raise questions about the appropriateness of SROs continuing to exercise quasi-regulatory powers as SROs. The CFTC is considering this issue. In a recent document the CFTC stated:

Starting with the CME in 2003, exchanges' continuing transformation from member-owned, not-for-profit entities to publicly-traded, for-profit businesses requires careful attention from the Commission. With the CBOT's initial public offering ("IPO") and listing completed in October 2005, the two largest U.S. futures exchanges, accounting for almost 87% of all futures volume in the U.S., are now public, for-profit companies. In addition, the New York Mercantile Exchange is preparing to sell a 10% stake in the exchange to a private equity group in anticipation of a 2006 IPO. At that time, over 97% of U.S. futures trades will be transacted on exchanges whose incentives, owners, and demands are different from the not-for-profit, member-owned model that has prevailed for over 100 years, and upon which member self-regulation is based.

The Commission is particularly interested in specific examples of instances where an SRO's new commercial motives and incentives may have altered its self-regulatory behavior. More generally, commenters should address whether and how demutualized, for-profit, publicly-traded entities might alter their regulatory behavior in an effort to gain competitive advantage, reduce costs, satisfy shareholder and earnings expectations, or meet other non-regulatory objectives. Such regulatory behavior could include over-regulation, under-regulation, or selective or discriminatory regulation. Specific examples, either in the SRO or DSRO context, are welcome.

Finally, the Commission wishes to draw interested parties' attention to the listing standards of the

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[77] John M Damgard, President, Futures Industry Association, Remarks for the CFTC Roundtable on Derivatives Clearing Organizations (Aug. 1, 2002) *available at* http://www.cftc.gov/files/opa/press02/opadamgard_020801.pdf

New York Stock Exchange ("NYSE"), which impact both the CME and the CBOT as their parent companies are listed on that exchange. Certain governance provisions in the listing standards are another new development since the beginning of the SRO Study... In particular, the NYSE now requires that the boards of directors of listed companies be majority independent, and provides detailed guidelines for determining a director's independence.

The Commission notes, however, that both the governance and independence provisions in the listing standards are directed at shareholder protection and broad corporate governance. Although listed futures exchanges and their shareholders may benefit from these provisions, they may not be relevant to fair, effective, and vigorous self-regulation.

The Commission is interested in receiving comments on the relationship between SROs' Commission-mandated self-regulatory responsibilities and the NYSE listing standards applicable to their parent companies, if any such relationship exists. Both the CME and the CBOT have determined that their member-directors are "independent" for purposes of the listing standards. Interested parties should comment on whether that determination is relevant to futures self-regulation.

II. Questions

The Commission has formulated the following questions based on its research, responses to previous Federal Register requests for comments, the views expressed by interview participants, and industry developments. Responses from interested parties will advance the Commission's understanding of issues relevant to conflicts of interest in self-regulation, SRO governance, and other relevant matters. Interested parties should also raise any additional issues that they believe will help the Commission's understanding of the issues presented. If interested parties believe that they have previously addressed any questions or issues related to this Request, and have no new information to add, they should feel free to refer the Commission to those responses.

Possible conflicts of interest, such as those that may exist between an SRO's regulatory responsibilities, its commercial interests, its members, and other constituents, are central to many of the questions articulated below. Where appropriate, parties should identify the specific conflict addressed in their response, and how their proposal resolves that conflict. With the SRO Study drawing to a conclusion, the Commission will carefully consider the need for additional guidance to insulate self-regulation from conflicts of interest and improper influence. Any such guidance will reflect the Commission's continuing commitment to industry self-regulation, flexible core principles, and responsible Commission oversight.

1. Is the present system of self-regulation an effective regulatory model for the futures industry?

2. As the futures industry adapts to increased competition, new ownership structures, and for-profit business models, what conflicts of interest could arise between:

(i) An SRO's self-regulatory responsibilities and the interests of its members, shareholders, and other stakeholders; and

(ii) An SRO's self-regulatory responsibilities and its commercial interests?

3. Given the ongoing industry changes cited above, please describe how self-regulation can continue to operate effectively. What measures have SROs taken thus far, and what additional

measures are needed, to ensure fair, vigorous, and effective self-regulation by competitive, publicly-traded, for-profit SROs?

4. What is the appropriate composition of SROs' boards of directors to ensure the fairness and effectiveness of their self-regulatory programs?

5. Should SROs' boards include independent directors, and, if so, what level of representation should they have? What factors are relevant to determining a director's independence?

6. Should self-regulation be overseen by an independent entity within an SRO?

(i) If so, what functions and authority should be vested in such an entity?

(ii) At least two futures exchanges have implemented board-level regulatory oversight committees ("ROCs") to oversee their regulatory functions in an advisory capacity. Commenters are invited to address any strengths or weaknesses in this approach.

7. The parent companies of some SROs are subject to the listing standards of the securities exchanges on which they are traded. Are such listing standards relevant to self-regulation and to conflicts of interest within DCMs?

8. What is the appropriate composition of SROs' disciplinary committees to ensure both expertise and impartiality in decision-making?

(i) Should a majority of committee members be independent? Should the composition of SROs' disciplinary committees reflect the diversity of the constituency? Should similar safeguards apply to other key committees and if so, which committees?

(ii) Should SRO disciplinary committees report to the board of directors, an independent internal body, or an outside body?

9. What information should SROs make available to the public to increase transparency (e.g., governance, compensation structure, regulatory programs and other related matters)? Are the disclosure requirements applicable to publicly traded companies adequate for SROs?

10. What conflicts of interest standards, if any, should apply specifically to DCOs, both stand-alone DCOs and those integrated within DCMs?

11. What conflict of interest standards, if any, should be applicable to third-party regulatory service providers, including registered futures associations, to ensure fair, vigorous, and effective self-regulation on their part?[78]

Similar issues are raised by the transformation of securities exchanges into for-profit business entities.

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78 CFTC, SELF-REGULATION AND SELF-REGULATORY ORGANIZATIONS IN THE FUTURES INDUSTRY, 70 Fed. Reg. 71090 (Nov. 25, 2005) *available at* http://a257.g.akamaitech.net/7/257/2422/01jan20051800/edocket.access.gpo.gov/2005/pdf/E5-6510.pdf

Derivatives transactions and risk: *De Kwiatkowski* v *Bear Stearns* [79]

This case excerpt illustrates some of the risks of trading in futures:

...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 "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.

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[79] 306 F.3d 1293 (2d. Cir., 2002)

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 gyration 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 Commmodity 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 FMC 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.”[80] 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).”[81] **Do you agree that these factors should weigh against liability for Bear Stearns in this case? Is there a credible argument that Kwiatowski’s behaviour clearly shows that he needed more protection than he received?**

[80] See p 61 above.

[81] See p 61 above.