INTERNATIONAL FINANCE - SPRING 2009

INTRODUCTION

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1.0 INTRODUCTION TO THE TRANSNATIONAL FINANCIAL SYSTEM

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

International financial activity therefore involves the payment system, whereby funds are transmitted around the world, and a number of different financial markets: foreign exchange markets, securities markets, debt markets and markets for derivative financial instruments.[2] 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.

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

Although transnational financial activity involves issues for regulators, it is

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

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

Recent events in the markets have raised new questions for the regulation of transnational financial transactions. The IMF, which has been subject to some challenges over the last few years,[3] now sees a new role for itself.[4] Olivier Blanchard, Economic Counsellor and Chief Economist of the IMF, has written:

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

Until very recently it was taken for granted that participants in international or transnational financial transactions were very wealthy individuals, large corporates and financial firms. But the remittance market illustrates that even people who are not very

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[3] The IMF has been criticized over the years, for example, critiques of conditionality and the Washington consensus, and of the IMF's non-representative governance arrangements. *See, e.g.*, http://www.imfsite.org/default.htm .

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

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

wealthy may engage on a regular basis in transnational financial transactions.[6] International financial institutions and domestic banking regulators and politicians have focused on the remittance market in which migrant workers rely on remittance services, which may be informal services or part of the formal financial system, to send money home to their families. However, the remittance market has suffered in recent months as countries around the world have moved into recession.

Although the amounts involved in individual remittance transactions may be small, the market as a whole is significant. Remittances to developing countries are estimated to reach 283 billion in 2008 compared to $265 billion in 2007.[7]

Remittance systems raise issues for regulators concerned about money laundering. For example the Financial Action Task Force has identified alternative (i.e. informal or unregulated) remittance systems as possible vehicles for money laundering.[8] A concern to prevent money laundering would therefore tend to make policy-makers prohibit remittances through unregulated channels, even if such channels were cheaper for customers than regulated channels. The remittance example illustrates that there may be a number of policy issues implicated by a particular financial market or type of transaction.

The costs of making overseas remittances may be steep. To send $100 from Florida to Haiti via Western Union costs $11 (it costs $14.99 to send the same amount to Mexico in minutes, and $9.99 to send the money to Mexico the following day).[9] In 2005, the UK's Department for International Development sponsored a website to help people remit money

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[6] On remittances see, e.g., the Inter-American Development Bank's resources at http://www.iadb.org/mif/subtopic.cfm?language=English&SUBTOPIC=REMS&TOPIC= .

[7] Dilip Ratha, Sanket Mohapatra and Zhimei Xu, Outlook for Remittance Flows 2008-2010: Growth Expected to Moderate Significantly, but Flows to Remain Resilient, Migration and Development Brief, 2 , Migration and Remittances Team, Development Prospects Group, The World Bank (Nov. 11, 2008) *available at* http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1110315015165/MD_Brief8.pdf . *See also, e.g.*, http://www.remittances.eu/.

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

[9] Quotes obtained via Western Union price shopper web pages on Dec. 6, 2008. Note that the quoted costs do not include any costs associated with currency exchange, which could increase the effective cost, depending on the exchange rate applied.

more cheaply.[10] Searching for the cost of sending money from the US (not Florida) to Haiti produced much higher costs than those reported by Western Union. But the sendingmoneyhome.com site did produce a lower quote (of $4.99) for sending $100 to Mexico via Xoom.com.[11]

The US House Committee on Financial Services held hearings in 2003 on the issue of whether remittance services should be regulated.[12] Regulation in countries from which payments are sent and into which payments are sent may affect the costs of sending money. For example, if a country prohibits credit unions but not banks from receiving remittances, credit unions in that country may be forced to become banks.[13] 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.[14] Cross-border transactions may affect local conditions in one domestic financial system: domestic financial markets are increasingly related to each other.

Remittances 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. But regulation involves compliance costs which tend to be borne by consumers of regulated services. Increasing the costs of providing remittance services in order to control money laundering by organised criminals harms the interests of non-criminal remitters of money.

Countries regulate domestic financial activity to protect investors, depositors, and other categories of consumer in order to preserve the domestic financial markets. The

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[10] *See* http://www.sendmoneyhome.org/ . See also UK Remittance Working Group, UK Remittance Market, (nov. 2005) *available at* http://www.dfid.gov.uk/pubs/files/uk-remittances-report.pdf .

[11] *See* http://www.xoom.com (offering money transmission services to a limited number of countries). This information was also collected on Dec. 6, 2008.

[12] *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).

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

[14] Researchers at the World Bank are investigating the impact of remittances on development.

essential functions of financial markets are relatively simple: they enable businesses to raise money, and investors to obtain a return on capital they do not need for current consumption. Both of these functions are crucial to the functioning of capitalist economies. Businesses need to ensure supplies of capital in order to grow, and investors need to be able to provide for their future needs. The functions are also linked, as, ultimately, the money that businesses use comes from investors. If investors do not feel safe in committing their money to the businesses which need the money, they will refuse to invest, perhaps hiding the money under their mattresses. Moreover, if financial firms fail their failures may be transmitted to other financial firms through the payments system.[15] Such failures harm confidence. Thus, governments are convinced of the need to act to maintain investor/depositor confidence in the financial markets. In recent months we have seen what happens when market participants lose confidence in the financial markets. In this period of turmoil, some of the regulatory mechanisms which had been designed to maintain confidence have turned out to be ineffective.[16]

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

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

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

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

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.[17]

Questions:

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

Are your views on these questions different in early 2009 from those you would have held a year ago ? Two years ago?

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

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

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

million. Enron subsequently.went into bankruptcy.[18] The Enron mess and other corporate collapses and scandals involving companies such as Tyco, Worldcom and Parmalat prompted regulators and legislators to act to protect investor confidence.[19] The scandals and collapses raised a number of different questions about the regulation of financial markets involving:
- the constraints on US corporate officers and directors
- ensuring that financial disclosures accurately reflect the financial condition of issuers of securities (e.g. accounting for securitization, principles-based versus rules-based accounting regulation, regulating auditors, certification of company accounts)
- how to make sure that financial analysts do not mislead investors as to the value of securities
- the role of credit rating agencies.[20]

McDonough said in 2002:

This past year brought widespread questioning of the quality and integrity of the information available to the market and the behavior of some corporate executives. Although the developments that gave rise to this questioning are regrettable, there has, in fact, been a positive side. The public uproar that these developments have created and the turmoil they have generated in the financial markets have been immensely powerful as forces for meaningful reform. I further believe that the painful experiences of this year will help educate a generation of younger managers about the importance of integrity and sound corporate governance based on independent oversight and strong internal checks and balances. [21]

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

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[18] Paul M. Healy, Krishna G. Palepu, *The Fall of Enron*, 17(2) J. OF ECON.PERSPECTIVES, 3, 4 (2003).

[19] For a graph of investor confidence levels see http://icf.som.yale.edu/Confidence.Index/ .

[20] 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.

[21] McDonough speech, note 17 above.

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.[22]

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

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

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

The survey we are releasing today shows that investors' attitudes toward the securities industry and their brokers are at their lowest levels since we began our survey in 1995. Investors told us they are

[22] 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.[23]

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

I want to make life easier for our companies. When I finish at the Commission, there is just one question I will ask myself: have I helped to create a better, simpler and lighter regulatory framework for doing business in the EU that works? And have I blocked some of the more extravagant ideas that business might otherwise have been burdened with? That is my personal benchmark.
Europe has to strive to be the best in the world, and nothing less. Strive to have a better regulatory framework than our competitors – business driven, prudentially sound, and sensible – with responsible levels of investor protection. We should aim to be the model for the emerging capital markets – and be open to innovative ways to cooperate with China, India, Brazil. And of course the United States.[24]

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

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

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

Sarbanes-Oxley Act of 2002[25] included a number of provisions which adversely affected foreign issuers of securities which had issued their securities in the US. After pressure from the EU the SEC worked to mitigate these harsh effects, and (again in 2005) Charlie McCreevy talked positively about the EU/US relationship:

We have an excellent financial markets relationship with the United States. No tension. Simple matter of fact meetings. Got a regulatory problem? Then let's sit down and work it through. That's our approach. Informal. Without the bureaucratic baggage. Without the "after you Cecil" language. Straight talking to resolve problems. And it works. This week we have seen another positive indicator – a point we have been consistently raising with them – that the US SEC has made a proposal to resolve the US deregistration problem. So the Hotel California is beginning to open and foreign issuers may be able to leave more easily. The SEC has delivered these proposals bang on time (i.e. exactly when they said they would). We are checking the details with our industry, but it is certainly a positive signal showing the willingness of our American counterparts to find a solution.[26]

Questions:

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?

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

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[25] Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745, July 30, 2002.

[26] *Id.*

We will look in detail at some of the current issues in financial regulation later. Regulators have been focusing on a range of safety and soundness issues with respect to banks, especially relating to liquidity and risk concentrations, and on issues relating to complex financial instruments (and the failure of credit rating agencies to rate such instruments accurately). The current problems illustrate the interconnection of the financial markets in different parts of the world. Már Gudmundsson, Deputy Head of the Monetary and Economic Department of the BIS (Bank for International Settlements) said in a speech in September 2008:[27]

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

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

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

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

[27] *See* http://www.bis.org/speeches/sp081119.htm .

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

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

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

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

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

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

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

The "shadow banking system" Gudmundsson refers to involves non-bank institutions which behave like banks, borrowing short (issuing commercial paper, which is short term debt) and lending long. These non-bank entities are not regulated in the same way that banks are, and have not been part of deposit insurance systems, nor have they had access to lender of last resort facilities available to banks.

2.0 INSTITUTIONS OF TRANSNATIONAL FINANCIAL REGULATION

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

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

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

At the supranational level there are international organizations which have an interest in financial markets and financial regulation. Different organizations have different mandates and structures. Some inter-governmental organizations, such as the Basle Committee on Banking Supervision, IOSCO (International Organisation of Securities Commissions), and the

IAIS (International Association of Insurance Supervisors) are essentially collaborative, technocratic organizations with the power to develop non-binding recommendations, principles and standards. The Basle Committee on Banking Supervision (BCBS) describes itself as follows:

The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the Committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. In this regard, the Committee is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision.
The Committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank.
The present Chairman of the Committee is Mr Nout Wellink, President of the Netherlands Bank.
The Committee encourages contacts and cooperation among its members and other banking supervisory authorities. It circulates to supervisors throughout the world both published and unpublished papers providing guidance on banking supervisory matters. Contacts have been further strengthened by an International Conference of Banking Supervisors (ICBS) which takes place every two years.[28]

In contrast to intergovernmental/inter-regulator organizations, the European Union has supranational institutions which function like a legislature, creating rules which are binding on its Member States and, in some circumstances, on people and businesses within those Member States. [29] Traditionally the EU has legislated for financial regulation using directives which require implementation in the Member States and thus function as instructions to the Member States to introduce rules which give effect to the provisions of the directives. More

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[28] *See* http://www.bis.org/bcbs/index.htm .

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

recently the EU has moved to trying to use regulations in some cases.[30] Regulations take effect directly within the legal systems of the Member States without any need for, or possibility of, implementing action by the Member States (like a federal statute).

The IMF is a treaty-based international organization which was founded in 1944 to govern the international monetary system to assure exchange rate stability and encourage IMF members to do away with exchange restrictions.[31] The IMF lends money to its member countries when they have needs for funding they are not able to meet in the financial markets. Recent events have increased demand for funds from the IMF. The IMF has funds available for crisis lending, and Iceland recently benefitted from this facility.[32] As part of its lending programs, the IMF examines the economies of the countries to which it lends, including their bank regulatory systems.[33] The IMF's interest in monitoring the financial soundness of its members, especially of its borrowers, gives it an interest in regulation as a mechanism for promoting financial stability.

The IMF participates in the work of the Financial Stability Forum (FSF), which was established in 1999, and which states that it "brings together senior representatives of national financial authorities (e.g. central banks, supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory

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[30] *See, e.g.*, Proposal for a Regulation of the European Parliament and of the Council On Credit Rating Agencies, COM(2008) 704 final (Nov. 12, 2008).

[31] You can find the Articles of Agreement of the International Monetary Fund at http://www.imf.org/external/pubs/ft/aa/index.htm .

[32] *See, e.g.*, IMF, Iceland: Financial System Stability Assessment—Update, IMF Country Report No. 08/368 (Dec. 2008) *available at* http://www.imf.org/external/pubs/ft/scr/2008/cr08368.pdf

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

groupings, committees of central bank experts and the European Central Bank".[34] The FSF has recently been working on issues relating to the global market turmoil.[35]

The World Bank (which also participates in the FSF) does not have a specific focus on financial regulation, although it has in recent years been interested in financial law and corporate governance as aspects of governance seen as crucial to economic development.[36] A recent paper states:

The process of globalization and financial development has been prone to crises. Over the long run, financial development is expected to support economic growth and poverty reduction. But, along the way, even relatively mature financial systems are vulnerable to systemic banking crises, cycles of booms and busts, and financial volatility. This appears to be partly intrinsic and partly due to policy mistakes. It arises as banks expand and capital markets generate new financial products. This entails new, unfamiliar, risks for financial intermediaries and regulators. Furthermore, as countries become more open to capital flows, crises are more easily transmitted across borders. The positive long-run relationship between financial development and growth coexists with a negative short-run relationship through financial fragility...
The most direct channel linking the developed world to the financial crisis emanating from the developed world in 2008 is through exposure to assets that are at the heart of the crisis, notably (though not only) the sub-prime mortgages. However, the more important channels for most developing countries will probably be indirect, notably through trade (via declining demand for developing- country exports or declining export process, including commodities), investment (as external finance contracts) and remittances (also stemming from the recession in the developed world).[37]

Other UN agencies have been involved in the negotiation of treaties which have an

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[34] http://www.fsforum.org/about/overview.htm

[35] *See, e.g.*, Financial Stability Forum, Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, (Apr. 2008) *available at* http://www.fsforum.org/publications/r_0804.pdf (Enhancing Resilience).

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

[37] The World Bank, Development Research Group, Lessons from World Bank Research on Financial Crises, 3-4, Policy Research Working Paper 4779 (Nov. 2008) *available at* http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2008/11/13/000158349_20081113111324/Rendered/PDF/WPS4779.pdf

impact on financial transactions. For example, UNCITRAL, the United Nations Model Commission on International Trade Law, has developed a Model Law on Cross-Border Insolvency, [38] and a Convention on the Assignment of Receivables in International Trade.[39]

Non-UN international organizations may also be involved in developing harmonized standards relevant to financial transactions. For example, Unidroit, the International Institute for the Unification of Private Law,[40] has an ongoing project on intermediated securities (securities held not directly by investors but indirectly through an intermediary such as a broker).[41] The OECD focuses on a range of issues relating to financial markets from general financial market trends[42] to corporate governance[43] and investor education.[44]

The interactions between domestic and supranational institutions form a system of multi-level governance for financial market activity. Here is an excerpt from a paper discussing some of the issues that arise in multi-level systems:[45]

Over time, supranational standard-setters have begun to formalise their standard-setting processes, developing their practices for consulting on proposed standards, and even establishing consultation policies.[46] However, the different organizations approach consultation and the reporting of the results

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[38] *See* http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html . See also, e.g., http://global.abiworld.org/ .

[39] *See* http://www.uncitral.org/uncitral/en/uncitral_texts/payments/2001Convention_receivables.html.

[40] http://www.unidroit.org/dynasite.cfm

[41] *See* http://www.unidroit.org/english/workprogramme/study078/item1/overview.htm.

[42] http://www.oecd.org/document/36/0,3343,en_2649_34849_1962020_1_1_1_37467,00.html

[43] http://www.oecd.org/topic/0,3373,en_2649_34813_1_1_1_1_37467,00.html

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

[45] Caroline Bradley, Financial Trade Associations and Multilevel Regulation. A version of this paper was published in Ramses Wessel, Andreas Follesdal & Jan Wouters eds., Multilevel Regulation and the EU: The Interplay between Global, European and National Normative Processes (2008).

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

of consultation differently,[47] and there is, so far, no harmonised supranational administrative law.[48] Consultation processes which exclude groups which are affected by harmonised rules because of a lack of transparency,[49] or because the issues are framed in ways which make the views of affected groups seem irrelevant, lack legitimacy. Consumers and the organisations which represent their interests are more likely than financial firms to be excluded from effective participation in supranational standard-setting due to the combined effects of opaque processes, framing, and lack of resources.

Some harmonised rules are set out in binding legal instruments, others are only hortatory. Even the EU's binding harmonisation measures sometimes leave to the Member States some discretion about how to implement the directives within their domestic legal systems.[50] Non-binding standards developed by bodies such as IOSCO may be implemented differently by different states, or may not be implemented at all.[51] However, even formally hortatory standards derive greater force, and become harder for domestic legislators and regulators to ignore, because international financial institutions (IFIs) such as the IMF encourage governments to adopt these standards.[52]

Financial regulation involves complex issues of regulatory jurisdiction, in which jurisdiction is allocated horizontally between authorities in different territorial areas,[53] and vertically between

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[47] See generally, e.g., C. Bradley, *Private International Law-Making for the Financial Markets*, 29 FORDHAM INT'L L. J. 127, 140-154 (2005).

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

[49] Cf. EU Commission, Green Paper: European Transparency Initiative, COM (2006) 194, May 3, 2006.

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

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

[52] See, e.g., *idem* at pp. 286-289.

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

authorities at different hierarchical levels within states, and at the supranational (regional or global) levels.[54] Within a domestic legal system the source for a rule of financial regulation may be sub-national, national, or supranational. Rules for the allocation of regulatory jurisdiction are established in statutes and treaties, but there can be uncertainty about the proper interpretation of the rules.[55]

Standards which are formally harmonised at the supranational level usually need to be implemented within domestic regulatory systems. Implementation is sometimes multilayered and indirect. For example, the Basle Committee has developed capital adequacy standards for banks involved in international banking.[56] Within the EU, capital adequacy requirements are an aspect of harmonised regulation of credit institutions, and the EU's capital adequacy rules are being amended to reflect the new Basle standards.[57] Competent authorities within the Member States are responsible for adjusting domestic capital adequacy requirements to reflect the new Basle standards as reflected in EU implementing measures.[58]

Where domestic legislators and regulators have discretion about how they carry out implementation, there are usually multiple points for influencing the regulatory process. Many different actors have a stake in the outcomes of these multi-level or multi-stage regulatory processes, from financial firms and their advisors to corporate and individual consumers of financial services.[59] But some stakeholders are in a better position to influence regulatory outcomes because of superior financial and other resources.

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[54] The complex web of regulation includes a significant component of privately generated standards and codes and contracts which may have quasi-regulatory effects. See, e.g., Bradley, *loc. cit.* note 47 at pp. 158-179.

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

[56] BIS, Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version*, Basel: BIS, June 2006.

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

[58] See, e.g., FSA, *Strengthening Capital Standards*, CP 05/03, London: FSA, January 2005.

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

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

The FTAs' other routine strategy relies on "harmonisation rhetoric," which is invoked in the context of domestic regulatory action.[60] Harmonisation rhetoric involves an argument that the rules in one domestic jurisdiction should not be stricter than those in another. The argument appears in the context of implementation of supranational standards or rules (for example, arguments against gold-plating when implementing EU directives)[61] and also arises to oppose rules proposed by domestic regulators that lack a supranational source. Harmonisation rhetoric can be seen as a subset of market protection rhetoric because those who invoke it would argue that more onerous rules in one jurisdiction limit the ability of firms established there to compete with firms established elsewhere. Harmonisation rhetoric may also include arguments for self-regulation, on the basis that self-regulatory standards and codes may be able to operate more effectively across territorial boundaries than state-based regulation.[62]

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[60] Harmonisation rhetoric is only necessary in the context of the development of supranational rules and standards in order to limit the discretion of the implementing authorities.

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

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

3.0 BEGINNING TO THINK ABOUT FINANCIAL INSTRUMENTS AND RISK

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

... the financial requirements for participation in futures trading, such as margin requirements and broker fees, may in fact deter some producers from using these markets. However, these requirements appear unavoidable. Either they are needed to ensure the financial integrity of the marketplace and that traders meet the financial obligations associated with their positions, or they are not subject to control by the exchanges or the Commission....
There are several explanations for the relatively low level of direct producer participation in agricultural futures and option markets. A commonly expressed view is that low producer participation is a consequence of a lack of understanding concerning the economic purposes and functioning of the markets. However, other considerations appear to be equally important in explaining producers' reluctance to use these markets. Specifically, the cost and the availability of substitute risk-shifting instruments, governmental programs, and business practices that are beyond the control of the exchanges and the Commission also appear to be significant factors. Nevertheless, the exchanges have an incentive to encourage participation in their markets, which they accomplish through careful contract design, market surveillance and rule enforcement, and extensive education and information dissemination programs. The Commission facilitates commercial use of the markets through vigorous enforcement of the Act and a flexible regulatory scheme that encourages exchange innovation to design contracts that meet the risk management needs of potential commercial users. The Commission operates an extensive market surveillance program that actively monitors the markets on a daily basis to detect attempts to manipulate prices. It also reviews new contracts and amendments to existing contracts to assure that the contract markets are not readily susceptible to manipulation, and it regularly monitors the exchanges' compliance with the Act's requirements to deter manipulation and to prevent trading abuses. The Commission also operates an active law enforcement program designed to prosecute fraud and oversees an industry registration program for commodity professionals that seeks to police their activities.[63]

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[63] 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

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, and derivatives transactions are regulated,[64] although some derivatives transactions may be subject to more regulation than others. Swap transactions tend to look more like individually negotiated contracts than exchange traded derivative products and as a result have been subject to less regulation,[65] although recent events have created some pressure for more regulation.

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 over time. Financial firms are developing new financial products and transactions all the time and regulators are often concerned that the firms which are involved in these products and transactions may not fully understand how the products/transactions

[64] 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).

[65] Banks which enter into swap contracts need to have regulatory capital in respect of risks associated with these contracts.

work and the risks which they involve. Regulators began to be concerned about the risks associated with credit derivatives before the current market turmoil, and recent events have exacerbated this concern. Credit derivatives transactions are supposed to transfer credit risk. Credit risk is the risk that a party to a financial transaction (such as a loan) will not be able to meet its obligations under the transaction. This would cause a loss to the other party or parties to the transaction. In the Spring of 2005, the BIS warned that if the parties to credit derivatives transactions did not understand the risks associated with those transactions, such transactions might threaten financial stability.[66] Credit derivatives can 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, at the end of 2005 the UK's Pension Protection Fund, which is responsible for pricing the risk that pension funds in the UK are underfunded, and which imposes levies which are used to compensate pension fund members who incur losses as a result of underfunding, suggested that it would not give pension funds credit for using credit default swaps (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.[67]

The International Swaps and Derivatives Association (ISDA) 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

[66] *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

[67] Pension Protection Fund, THE PENSION PROTECTION LEVY CONSULTATION DOCUMENT, para. 2.3.27 (Dec. 2005) *available at* http://www.pensionprotectionfund.org.uk/rbl_consultation_dec2005.pdf .

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.[68]

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

Participants in the derivatives markets (like participants in other financial markets) may be concerned about being subjected to different regulatory requirements in the different national markets in which they operate. The CFTC and the EU have agreed to co-operate in relation to the regulation of derivatives.[69]

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

Since 2005, the Commission's staff has received a substantial number of requests for guidance on the propriety of offering and trading financial agreements that may primarily function as information aggregation vehicles. These event contracts generally take the form of financial agreements linked to eventualities or measures that neither derive from, nor correlate with, market prices or broad economic or commercial measures. Event contracts have been based on a wide variety of interests including the results of presidential elections, the accomplishment of certain scientific advances, world population levels, the adoption of particular pieces of legislation, the outcome of corporate product sales, the declaration of war and the length of celebrity marriages. In response to the various requests for guidance, and to promote regulatory certainty, the Commission has commenced a comprehensive review of the Act's applicability to event contracts and markets.[70]

Questions:

Do you think that the distinction between hedging and speculation should be

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

[69] *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

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

significant for financial regulation? Should regulation discourage speculation? Should regulation discourage speculation generally, or only by people who cannot properly evaluate the risks? How can we tell whether people can evaluate the risks of speculation?

Different countries may regulate different types of financial activity in different ways. So, firms which are regulated in one country and which want to carry on business in another country may find it difficult to gain access to the second country's financial markets,[71] 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.[72] NAFTA also contains a Chapter on Financial Services.[73] Within systems for free trade in services, there is always the question whether a particular national rule is a prohibited interference with free trade, or is a legitimate means of ensuring consumer protection. For example, Paragraph 2 of the GATS Annex on Financial Services states:

2. *Domestic Regulation*

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

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

Questions:

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?

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

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

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

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.[74]

The EU seeks to integrate financial markets by removing barriers and by agreeing on harmonized rules on financial services, but the process of harmonizing the rules is a slow one. Harmonization of regulation is difficult even where the countries involved are at similar levels of economic development, and have similar cultural environments. Where culture and history diverge, harmonization is even more problematic.[75] We will think about regulatory harmonization in more detail later.

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

Regulatory harmonization also limits the ability of firms to escape regulation by moving their activities into another jurisdiction (regulatory arbitrage). International harmonization of money laundering regulation is an example of this concern at work (there is some material on money laundering below). In November 2002 the IMF agreed to include " the Financial Action Task Force (FATF) 40 Recommendations on an effective anti-money laundering framework,

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[74] *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

[75] *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).

and the 8 Special Recommendations on Terrorism Financing (FATF 40+ 8), to the list of areas and associated standards and codes that are incorporated into the operational work of the Fund".[76] This means that the IMF monitors the application of these recommendations as it monitors other aspects of the countries whose affairs it reviews.

Legal harmonization is also designed to protect countries from the effects of financial crises which affect other countries. For example, a 2002 report argues 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." [77]

Crises in developing markets during the 1990s led to general concern about the "International Financial Architecture",[78] and to the setting up of the Financial Stability

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[76] 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

[77] 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

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

Institute.[79] 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.[80] 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.

Question (which we may not be able to answer yet, if at all):
Why did the institutional structures designed to ensure financial stability fail?

Different reasons for legal and regulatory harmonization 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).[81]

Critics of harmonization argue that legal harmonization has risks:

I am also concerned that the effort to homogenize capital rules across the world may do serious damage to certain markets in which U.S. banks – particularly national banks – have been world

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

[80] *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

[81] Contact Group Report, note 77 above, at 1.

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.[82]

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

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

4.0 READINGS:

1. Derivatives transactions: excerpt from Chicago Mercantile Exchange Holdings, Inc. (CME), Prospectus for Sale of Class A Common Stock, (Dec. 6, 2002)[83]

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

A futures contract is a derivatives product that provides the means for hedging, speculation and asset allocation and is used in nearly all sectors of the global economy. Those who trade futures essentially trade contracts to buy or sell an underlying commodity or financial instrument at a specific date in the

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[82] 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

[83] At pp 65-68. The document is *available at* http://www.sec.gov/Archives/edgar/data/1156375/000104746902006277/a2095862zex-99_1.htm

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, 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.

The CME prospectus excerpt illustrates that 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.[84]

Questions:

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

[84] Note 82 above, at 15.

on earth. And we need to think about how for profit companies might use that market power.[85]

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 organizations (SROs). Changes in the ownership structure of exchanges raise questions about the appropriateness of SROs continuing to exercise quasi-regulatory powers as SROs. In 2005 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 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

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[85] 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

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?[86]

Similar issues are raised by the transformation of securities exchanges into for-profit business entities. IOSCO has recognized a significant shift of exchanges from mutual organizations to for-profit organizations:

Traditionally, exchanges were owned by the market participants and were responsible for the regulation of both the markets they operated and of the members themselves. They were member-owned, self-regulatory organisations in the full sense of those terms. However, in recent years, the rationale and support for continuing mutual ownership has tended to weaken and most

[86] 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

major exchanges have now converted into for-profit companies with broader shareholder bases.[87]

2. Derivatives transactions and risk: *De Kwiatkowski* v *Bear Stearns* [88]

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

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[87] Technical Committee, Int'l Org. of Secs. Comm'ns, Consultation Report - Regulatory Issues Arising From Exchange Evolution, (May 2006) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD212.pdf .

[88] 306 F.3d 1293 (2d. Cir., 2002)

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.

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.”[89] 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).”[90]

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[89] See p 48 above.

[90] See p 48 above.

Questions:

Do you agree that these factors should weigh against liability for Bear Stearns in this case? Is there a credible argument that Kwiatowski's behavior shows that he needed more protection than he received?

3. Intermediated and disintermediated finance: William R White, Economic Adviser, Bank for International Settlements, *Financial markets: shock absorbers or shock creators?*[91]

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

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[91] Speech at the Fourth Geneva Conference on the World Economy, Geneva, (May 10, 2002). You can find the speech 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.

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 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."

Questions:

White is concerned with how to protect financial markets. What issues does he identify? How are bank-based financial markets different from capital markets?[92] What do you think he means about the issue of rules versus discretion?

4. Non-bank payment systems: Financial Action Task Force (FATF), Special Recommendations on Terrorist Financing (Oct. 22, 2004)

I. Ratification and implementation of UN instruments
Each country should take immediate steps to ratify and to implement fully the 1999 United Nations International Convention for the Suppression of the Financing of Terrorism.
Countries should also immediately implement the United Nations resolutions relating to the prevention and suppression of the financing of terrorist acts, particularly United Nations Security Council Resolution 1373.
II. Criminalising the financing of terrorism and associated money laundering
Each country should criminalise the financing of terrorism, terrorist acts and terrorist organisations. Countries should ensure that such offences are designated as money laundering predicate offences.

III. Freezing and confiscating terrorist assets
Each country should implement measures to freeze without delay funds or other assets of terrorists, those who finance terrorism and terrorist organisations in accordance with the United Nations resolutions relating to the prevention and suppression of the financing of terrorist acts.
Each country should also adopt and implement measures, including legislative ones, which would

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

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.[93] Cash Couriers
Countries should have measures in place to detect the physical cross-border transportation of currency and bearer negotiable instruments, including a declaration system or other disclosure obligation.
Countries should ensure that their competent authorities have the legal authority to stop or restrain currency or bearer negotiable instruments that are suspected to be related to terrorist financing or money laundering, or that are falsely declared or disclosed.
Countries should ensure that effective, proportionate and dissuasive sanctions are available to deal with persons who make false declaration(s) or disclosure(s). In cases where the currency or bearer negotiable instruments are related to terrorist financing or money laundering, countries should also adopt measures, including legislative ones consistent with Recommendation 3 and Special Recommendation III, which would enable the confiscation of such currency or instruments.

"Money service businesses" are subject to money laundering regulation in many jurisdictions, as well as banks and other types of financial firm.[94] This idea that services "for the transmission of money or value" should be regulated catches informal value transmission systems.

5. Declaration of the Summit on Financial Markets and the World Economy [95]

1. We, the Leaders of the Group of Twenty, held an initial meeting in Washington on November 15, 2008, amid serious challenges to the world economy and financial markets. We are determined to enhance our cooperation and work together to restore global growth and achieve needed reforms in the world's financial systems.
2. Over the past months our countries have taken urgent and exceptional measures to support the global economy and stabilize financial markets. These efforts must continue. At the same time, we must lay the foundation for reform to help to ensure that a global crisis, such as this one, does not happen again. Our work will be guided by a shared belief that market principles, open trade and investment regimes, and effectively regulated financial markets foster the dynamism, innovation, and entrepreneurship that are essential for economic growth, employment, and poverty reduction.

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

[94] See, generally, e.g., http://www.msb.gov/new/index.html

[95] (Nov. 15, 2008) *available at* http://www.whitehouse.gov/news/releases/2008/11/20081115-1.html

Root Causes of the Current Crisis
3. During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.
4. Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruption.

Actions Taken and to Be Taken
5. We have taken strong and significant actions to date to stimulate our economies, provide liquidity, strengthen the capital of financial institutions, protect savings and deposits, address regulatory deficiencies, unfreeze credit markets, and are working to ensure that international financial institutions (IFIs) can provide critical support for the global economy.
6. But more needs to be done to stabilize financial markets and support economic growth. Economic momentum is slowing substantially in major economies and the global outlook has weakened. Many emerging market economies, which helped sustain the world economy this decade, are still experiencing good growth but increasingly are being adversely impacted by the worldwide slowdown.
7. Against this background of deteriorating economic conditions worldwide, we agreed that a broader policy response is needed, based on closer macroeconomic cooperation, to restore growth, avoid negative spillovers and support emerging market economies and developing countries. As immediate steps to achieve these objectives, as well as to address longer-term challenges, we will:
 * Continue our vigorous efforts and take whatever further actions are necessary to stabilize the financial system.
 * Recognize the importance of monetary policy support, as deemed appropriate to domestic conditions.
 * Use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability.
 * Help emerging and developing economies gain access to finance in current difficult financial conditions, including through liquidity facilities and program support. We stress the International Monetary Fund's (IMF) important role in crisis response, welcome its new short-term liquidity facility, and urge the ongoing review of its instruments and facilities to ensure flexibility.
 * Encourage the World Bank and other multilateral development banks (MDBs) to use their full capacity in support of their development agenda, and we welcome the recent introduction of new

facilities by the World Bank in the areas of infrastructure and trade finance.
* Ensure that the IMF, World Bank and other MDBs have sufficient resources to continue playing their role in overcoming the crisis.

Common Principles for Reform of Financial Markets

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

9. We commit to implementing policies consistent with the following common principles for reform.
* Strengthening Transparency and Accountability: We will strengthen financial market transparency, including by enhancing required disclosure on complex financial products and ensuring complete and accurate disclosure by firms of their financial conditions. Incentives should be aligned to avoid excessive risk-taking.
* Enhancing Sound Regulation: We pledge to strengthen our regulatory regimes, prudential oversight, and risk management, and ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances. We will exercise strong oversight over credit rating agencies, consistent with the agreed and strengthened international code of conduct. We will also make regulatory regimes more effective over the economic cycle, while ensuring that regulation is efficient, does not stifle innovation, and encourages expanded trade in financial products and services. We commit to transparent assessments of our national regulatory systems.
* Promoting Integrity in Financial Markets: We commit to protect the integrity of the world's financial markets by bolstering investor and consumer protection, avoiding conflicts of interest, preventing illegal market manipulation, fraudulent activities and abuse, and protecting against illicit finance risks arising from non-cooperative jurisdictions. We will also promote information sharing, including with respect to jurisdictions that have yet to commit to international standards with respect to bank secrecy and transparency.
* Reinforcing International Cooperation: We call upon our national and regional regulators to formulate their regulations and other measures in a consistent manner. Regulators should enhance their coordination and cooperation across all segments of financial markets, including with respect to

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

Tasking of Ministers and Experts
10. We are committed to taking rapid action to implement these principles. We instruct our Finance Ministers, as coordinated by their 2009 G-20 leadership (Brazil, UK, Republic of Korea), to initiate processes and a timeline to do so. An initial list of specific measures is set forth in the attached Action Plan, including high priority actions to be completed prior to March 31, 2009.
In consultation with other economies and existing bodies, drawing upon the recommendations of such eminent independent experts as they may appoint, we request our Finance Ministers to formulate additional recommendations, including in the following specific areas:
 * Mitigating against pro-cyclicality in regulatory policy;
 * Reviewing and aligning global accounting standards, particularly for complex securities in times of stress;
 * Strengthening the resilience and transparency of credit derivatives markets and reducing their systemic risks, including by improving the infrastructure of over-the-counter markets;
 * Reviewing compensation practices as they relate to incentives for risk taking and innovation;
 * Reviewing the mandates, governance, and resource requirements of the IFIs; and
 * Defining the scope of systemically important institutions and determining their appropriate regulation or oversight.
11. In view of the role of the G-20 in financial systems reform, we will meet again by April 30, 2009, to review the implementation of the principles and decisions agreed today.

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

contraction of capital flows, including to developing countries.
13. We underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty. In this regard, within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures to stimulate exports. Further, we shall strive to reach agreement this year on modalities that leads to a successful conclusion to the WTO's Doha Development Agenda with an ambitious and balanced outcome. We instruct our Trade Ministers to achieve this objective and stand ready to assist directly, as necessary. We also agree that our countries have the largest stake in the global trading system and therefore each must make the positive contributions necessary to achieve such an outcome.
14. We are mindful of the impact of the current crisis on developing countries, particularly the most vulnerable. We reaffirm the importance of the Millennium Development Goals, the development assistance commitments we have made, and urge both developed and emerging economies to undertake commitments consistent with their capacities and roles in the global economy. In this regard, we reaffirm the development principles agreed at the 2002 United Nations Conference on Financing for Development in Monterrey, Mexico, which emphasized country ownership and mobilizing all sources of financing for development.
15. We remain committed to addressing other critical challenges such as energy security and climate change, food security, the rule of law, and the fight against terrorism, poverty and disease.
16. As we move forward, we are confident that through continued partnership, cooperation, and multilateralism, we will overcome the challenges before us and restore stability and prosperity to the world economy.

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

Strengthening Transparency and Accountability
Immediate Actions by March 31, 2009
* The key global accounting standards bodies should work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products, especially during times of stress.
* Accounting standard setters should significantly advance their work to address weaknesses in accounting and disclosure standards for off-balance sheet vehicles.
* Regulators and accounting standard setters should enhance the required disclosure of complex financial instruments by firms to market participants.

* With a view toward promoting financial stability, the governance of the international accounting standard setting body should be further enhanced, including by undertaking a review of its membership, in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities.
* Private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded FSF, and other relevant bodies.

Medium-term actions

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

Enhancing Sound Regulation

Regulatory Regimes

Immediate Actions by March 31, 2009

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

Medium-term actions

* To the extent countries or regions have not already done so, each country or region pledges to review and report on the structure and principles of its regulatory system to ensure it is compatible with a modern and increasingly globalized financial system. To this end, all G-20 members commit to undertake a Financial Sector Assessment Program (FSAP) report and support the transparent assessments of countries' national regulatory systems.
* The appropriate bodies should review the differentiated nature of regulation in the banking, securities, and insurance sectors and provide a report outlining the issue and making recommendations on needed improvements. A review of the scope of financial regulation, with a special emphasis on institutions, instruments, and markets that are currently unregulated, along with ensuring that all systemically-important institutions are appropriately regulated, should also be

undertaken.
 * National and regional authorities should review resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly wind-down of large complex cross-border financial institutions.
 * Definitions of capital should be harmonized in order to achieve consistent measures of capital and capital adequacy.

Prudential Oversight
Immediate Actions by March 31, 2009
 * Regulators should take steps to ensure that credit rating agencies meet the highest standards of the international organization of securities regulators and that they avoid conflicts of interest, provide greater disclosure to investors and to issuers, and differentiate ratings for complex products. This will help ensure that credit rating agencies have the right incentives and appropriate oversight to enable them to perform their important role in providing unbiased information and assessments to markets.
 * The international organization of securities regulators should review credit rating agencies' adoption of the standards and mechanisms for monitoring compliance.
 * Authorities should ensure that financial institutions maintain adequate capital in amounts necessary to sustain confidence. International standard setters should set out strengthened capital requirements for banks' structured credit and securitization activities.
 * Supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps (CDS) in some countries, should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes.

 Medium-term actions
 * Credit Ratings Agencies that provide public ratings should be registered.
 * Supervisors and central banks should develop robust and internationally consistent approaches for liquidity supervision of, and central bank liquidity operations for, cross-border banks.

Risk Management
Immediate Actions by March 31, 2009
 * Regulators should develop enhanced guidance to strengthen banks' risk management practices, in line with international best practices, and should encourage financial firms to reexamine their internal controls and implement strengthened policies for sound risk management.
 * Regulators should develop and implement procedures to ensure that financial firms implement policies to better manage liquidity risk, including by creating strong liquidity cushions.
 * Supervisors should ensure that financial firms develop processes that provide for timely and comprehensive measurement of risk concentrations and large counterparty risk positions across

products and geographies.
 * Firms should reassess their risk management models to guard against stress and report to supervisors on their efforts.
 * The Basel Committee should study the need for and help develop firms' new stress testing models, as appropriate.
 * Financial institutions should have clear internal incentives to promote stability, and action needs to be taken, through voluntary effort or regulatory action, to avoid compensation schemes which reward excessive short-term returns or risk taking.
 * Banks should exercise effective risk management and due diligence over structured products and securitization.

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

Promoting Integrity in Financial Markets
Immediate Actions by March 31, 2009
 * Our national and regional authorities should work together to enhance regulatory cooperation between jurisdictions on a regional and international level.
 * National and regional authorities should work to promote information sharing about domestic and cross-border threats to market stability and ensure that national (or regional, where applicable) legal provisions are adequate to address these threats.
 * National and regional authorities should also review business conduct rules to protect markets and investors, especially against market manipulation and fraud and strengthen their cross-border cooperation to protect the international financial system from illicit actors. In case of misconduct, there should be an appropriate sanctions regime.

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

Lack of transparency and a failure to exchange tax information should be vigorously addressed.

Reinforcing International Cooperation
Immediate Actions by March 31, 2009
 * Supervisors should collaborate to establish supervisory colleges for all major cross-border financial institutions, as part of efforts to strengthen the surveillance of cross-border firms. Major global banks should meet regularly with their supervisory college for comprehensive discussions of the firm's activities and assessment of the risks it faces.
 * Regulators should take all steps necessary to strengthen cross-border crisis management arrangements, including on cooperation and communication with each other and with appropriate authorities, and develop comprehensive contact lists and conduct simulation exercises, as appropriate.

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

Reforming International Financial Institutions
Immediate Actions by March 31, 2009
 * The FSF should expand to a broader membership of emerging economies.
 * The IMF, with its focus on surveillance, and the expanded FSF, with its focus on standard setting, should strengthen their collaboration, enhancing efforts to better integrate regulatory and supervisory responses into the macro-prudential policy framework and conduct early warning exercises.
 * The IMF, given its universal membership and core macro-financial expertise, should, in close coordination with the FSF and others, take a leading role in drawing lessons from the current crisis, consistent with its mandate.
 * We should review the adequacy of the resources of the IMF, the World Bank Group and other multilateral development banks and stand ready to increase them where necessary. The IFIs should also continue to review and adapt their lending instruments to adequately meet their members' needs and revise their lending role in the light of the ongoing financial crisis.
 * We should explore ways to restore emerging and developing countries' access to credit and resume private capital flows which are critical for sustainable growth and development, including ongoing infrastructure investment.
 * In cases where severe market disruptions have limited access to the necessary financing for counter-cyclical fiscal policies, multilateral development banks must ensure arrangements are in place to support, as needed, those countries with a good track record and sound policies.

Medium -term actions

* We underscored that the Bretton Woods Institutions must be comprehensively reformed so that they can more adequately reflect changing economic weights in the world economy and be more responsive to future challenges. Emerging and developing economies should have greater voice and representation in these institutions.
* The IMF should conduct vigorous and even-handed surveillance reviews of all countries, as well as giving greater attention to their financial sectors and better integrating the reviews with the joint IMF/World Bank financial sector assessment programs. On this basis, the role of the IMF in providing macro-financial policy advice would be strengthened.
* Advanced economies, the IMF, and other international organizations should provide capacity-building programs for emerging market economies and developing countries on the formulation and the implementation of new major regulations, consistent with international standards.