

*The Futures Industry: From Commodities to the Over-The-Counter Derivatives Markets-Origin, Purpose, Development, Controversy, and Regulation of the Most Volatile Financial Contracts in the World.*

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## INTRODUCTION TO THE FUTURES MARKETS

The Futures markets are often overshadowed by the highly prolific and actively traded securities markets. Only a few token moments on the popular financial television programs are devoted to the Futures Markets with just a handful of prices quickly flashed across the screen as the program fades away for commercial break.

Lack of television coverage may seem to indicate that Futures are somewhat insignificant as compared to the securities markets. However, such a caricature borders on economic heresy as Futures are no longer confined to traditional commodity markets from which they evolved. Historically, Futures were called “Commodities” or “Commodity Futures”. However, explosive growth during the last two decades has occurred with Futures contracts expanding into many new frontiers such as “energy” (crude oil, unleaded gas, heating oil, natural gas, and electricity), “currencies” (British Pound, Japanese Yen, Swiss Franc, Euro Currency, and U.S. Dollar Index), “interest rates” (Eurodollar, T-Bonds, T-Notes), and “stock indexes” (S&P 500, Nasdaq, Dow Jones). Today, the term “Commodities” (although still in use) is slowly being replaced in favor of the more general and all-inclusive term, *Futures*.

Entities concerned about fluctuations in these markets transcend the typical grain and livestock producers of past decades. Today, oil and gas producers, mutual fund companies, hedge funds, domestic and multinational corporations, publicly traded companies, utilities, municipalities, states, foreign countries, insurance companies, banks, and other institutions realize their financial stability is not guaranteed should they fail to properly manage their price risk exposure. Futures and Options are the essential tools that market participants use in order to reduce price risks and insure the predictability of profits as they strive for long term financial viability.

The regulatory framework of the Futures Markets was initially designed to guarantee that all transactions would be traded on regulated exchanges through regulated intermediaries subject to a margin requirement system.

During the last two decades, Futures have evolved into other financial products called “Derivatives” which trade *off-exchange* on the Over-the-Counter (OTC) Market in contrast to the typical Futures contracts. During the 1990’s, the OTC Derivatives mushroomed into a market that was three times

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larger than *exchange traded* contracts.<sup>1</sup> Subsequently, entities trading in Derivatives suffered millions of dollars in losses due to alleged fraud, lack of expertise, poor internal supervision, and improper leverage, while others blatantly failed to appreciate the underpinnings of Derivatives and the colossal risks associated with these financial instruments. Despite the controversy surrounding Derivatives, courts held that these instruments were not securities, therefore, they could not be regulated as such.<sup>2</sup> To solidify their existence, Congress amended the Securities Act of 1933 in the Graham-Leach-Bliley Act to exclude non-security based swaps (swaps are the most common type of Derivative contract) from the definition of a security.<sup>3</sup> Finally, Congress went even further to resolve any question as to the legitimacy of Derivatives when it enacted the Commodity Futures Modernization Act of 2000 (CFMA), which provided for legal certainty for these off-exchange traded contracts, prevented the SEC from regulating security-based swaps, and settled the issue as to who would regulate this largest sector of the Futures industry.<sup>4</sup>

The purposes of this article are to (1) explain the foundational function of *Hedging* and the market participants engaged in this risk management activity, (2) elucidate the historical oversight of the *exchange traded* Futures Markets, as well as its overseer, the Commodity Futures Trading Commission, (3) highlight the strategies that risk managers use

to transfer price exposure onto the Futures & Options markets, and (4) summarize the recent proliferation of *off-exchange* traded Swaps, Hybrids, and other financial futures contracts known as *Derivatives*, as well as the political battle to keep these highly leveraged and powerful instruments virtually unregulated.

## **I. HEDGING: THE FOUNDATIONAL PURPOSE OF THE FUTURES MARKETS**

In theory, Commodity Futures are basically “publicly traded forward contracts.”<sup>5</sup> Cash forward contracts still survive today in many commodities. For example, a forward contract (also called a cash contract) would occur when a wheat farmer enters into a pricing contract with a grain merchant or miller. Assume that a farmer had just planted his seed wheat in the fall but his wheat crop will not be ready for harvest until summer. A cash forward contract may be drawn up between the farmer and the grain merchant. Even though the wheat had just been planted and harvest was more than six months away, the contract would provide that the farmer deliver his wheat crop to the grain merchant, specifying a certain number of *bushels*, of a certain *quality*, on a certain *date*, at some specified *price*. Because this contract “locks in” a specific, agreed-to-price, the farmer foregoes any opportunity to participate in higher prices (which benefits the grain merchant) should the wheat market continue to rise into the summer harvest. If, however,

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<sup>1</sup> Russell Wasendorf, Sr., *Innovation Deserves More than 15 Minutes of Fame*, Stocks, Futures & Options Magazine, 21, 24 (June 2003).

<sup>2</sup> *Proctor & Gamble Co., v. Bankers Trust*, 925 F. Supp. 1270, 1276 (S.D. Ohio 1996).

<sup>3</sup> See Gramm-Leach-Bliley Act, 15 USC, Subchapter 1, § 6801-6890 and § 2A of the Securities Act of 1933.

<sup>4</sup> Commodity Futures Modernization Act of 2000.

<sup>5</sup> Stuart R. Veale, *Stocks, Bonds, Options, Futures* 209 (New York Institute of Finance 2001).

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the price of wheat moves lower into harvest, then the farmer would benefit from the cash contract (to the detriment of the grain merchant) since the previously negotiated price was higher. In both scenarios, the farmer brings his wheat to the grain merchant shortly after it is harvested thus “delivering” the quantity of bushels as provided for in the contract.<sup>6</sup>

Basic contract law principles apply as the farmer looks to the grain merchant for performance of the contract (payment for delivering the wheat). Likewise, the grain merchant looks to the farmer to perform in accordance with the terms of the contract (delivering a certain number of bushels, of a certain quality, by a certain date). However, suppose the price of wheat doubles or even triples by harvest time. The farmer may be tempted to default (fails to deliver the wheat to the grain merchant) and just sells the wheat to someone else at the existing market price, thus breaching his contract with the grain merchant in order to get the higher price on the spot market. Now, the grain merchant will still need the wheat after harvest because most likely it will have other contracts to fulfill with flour mills to deliver wheat during that time. Therefore, the grain merchant may be forced to buy wheat on the open market at the higher price to make good on its other contracts and later sue the farmer for damages incurred due to the farmer’s breach (failure of the farmer to deliver wheat at the previously agreed price).

This opportunity for breach is referred to as “counter-party risk” which is present when two parties enter into a contract. Likewise, the farmer has counterparty risk because if the price of wheat drops precipitously, then the

grain merchant may be the one tempted to breach (especially if they had guessed wrong on the market direction and failed to lay off this risk by offsetting cash contracts with flour mills or other end users of wheat). Law students (in first year Contracts) learn that many breach of the contract cases occur during times of rapid price inflation and deflation in the economy. Large price moves (in either direction) catch many market participants off-guard, which, in turn, causes extreme financial repercussions to the contracting parties. This counter-party risk (i.e. failure of one party to perform) is the most often underestimated risk component of any transaction, especially when the contract involves the price performance of a commodity or futures market.

One of the benefits of using *exchange traded futures contracts* (rather than cash forward contracts or off-exchange Derivatives contracts) is that *the counter-party is now a U.S. Commodity Exchange* as opposed to an individual or corporation. The exchange acts as a buyer for every seller and a seller for every buyer on each transaction.

While the Futures markets originated with grain contracts in the mid-1800’s, it wasn’t until the 1970’s when they first expanded into “perishable” commodities such as cattle and hogs. Each futures contract has a “contract size” that is very important in determining how many contracts will be needed in the transaction. Regardless of the contemplated Futures contract, a hedger should always begin by looking at the contract size to determine how many contracts are needed.<sup>7</sup> Once the hedge has been placed through the broker and the trade executed on the trading floor, the broker should immediately “report

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<sup>6</sup> Interview with Steve Smola, president, Beef Group, Inc. (formerly president of Wheeler Brothers Grain) (March 5, 2004).

<sup>7</sup> Interview with Harlan Coit, President, OKC West Livestock Auction Market (February 26, 2004).

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the fill” (execution price) to the client. Thereafter, if the futures markets rallies (which means that the futures position is incurring losses), the clearing firm will require the cattleman to post extra margin if he wants to maintain the positions. If the futures position generated a loss, most likely that futures market loss will be offset by his receiving a higher price in the cash market for the commodities.

In the scenario when the hedger guessed right (placing hedges before the market dropped) the hedger is very proud because, had there been no hedges, there would have been no futures profits to offset the losses sustained by the falling cash market. At the conclusion of the hedge, a cattleman waiting to hedge a cash position would still take his cattle to market when they are ready to sell and then simultaneously call his broker to offset the futures hedge. Although the cash and futures transactions mirror one another, they still are separate and distinct transactions (with separate parties) with their own respective obligations. Frequently when a bank is financing the cattle operation, the lender may require under the loan agreement that the cattlemen hedge some percentage of the cattle. While risk management strategies are infinite with varying degrees of risk and reward, this is the foundational premise for most hedging activity regardless of the underlying commodity.

Futures Markets were also designed to allow “commercials” (large grain merchants) to fulfill their hedging needs and purposes. A commercial hedger might employ a “long hedge”. This would occur when one would “buy” the futures contract to lock in the price. In all of these transactions, hedgers using the futures have the ability to determine what percentage they want to hedge and they also have the ability to determine how long they want to hold onto the hedge (not exceeding the end date of the contract). However, there is no requirement to hold the hedge all of the way to expiration of the futures contract. In

fact, many producers engage in what is called “spec-hedging” which means they are hedging, but if the futures market goes in their favor by an acceptable amount, then they will take their profit and move back to a neutral or “un-hedged position”. This is where the term “spec” is used which is short for “speculation”.

Livestock producers, grain producers, agricultural commercial firms, energy companies, and other hedgers (remember hedgers are those who own or expect to own the underlying commodity) are not the only one who use Futures. Small and large speculators, commodity funds, floor traders, hedge funds, mutual funds, professional money managers, banks, and other financial institutions also participate in buying and selling Futures contracts depending on their market outlooks, trading objectives, risk management plans, time horizons, and availability of risk capital.

Even though hedging was the initial purpose that led to Futures trading, the market does not know (nor does it care) if the underlying cash commodity is owned by either of the parties in a Futures transaction. The fact that the trader may own the underlying cash commodity is what classifies one as a “hedger”.

Unlike the stock market, Futures trading is a “zero-sum game”. This means that for every winning Futures position there is a loser and for every losing Futures position there is a winner. In absolute terms, money is not created or destroyed through trading, it is merely *transferred*. Another distinguishing characteristic of the Futures markets is that it is very easy for a trader to initiate a short position (“sell short”) when one suspects a market may decline (unlike the stock market, there is no “down-tick rule” in Futures).

Each Futures exchange itself acts as a buyer for every seller and a seller for every buyer. The exchange’s clearing house not only clears all of these trades but also collects funds each

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and every day (through the process of the initial and maintenance margin call requirements) from the losers to pay to the winners. In Futures, these positions (and subsequent change in account balances) are “marked to the market”, which means funds are credited or debited to each account on a daily basis. Therefore, existing profits that have not been realized (by an offsetting transaction) are still available in the account to withdraw or can be used to margin other positions.

In most Futures markets, the trading pits still exist. This method of trading is called “open outcry”, where floor traders use a flurry of hand signals coupled with intense screaming and yelling at one another as they execute the trades in the pit. Thousands of contracts trade on a daily basis as the market reacts to a variety of factors on its never ending quest of “price discovery”. Price quotations run out into future months.

## II. REGULATION OF THE COMMODITY FUTURES INDUSTRY

Regulation of the Futures Industry was under the domain of the states until Congress passed the Grain Futures Act of 1922 which was signed into law by President Warren Harding.<sup>8</sup> The Grain Futures Act (which predates the Securities Act of 33 and the

Securities Exchange Act of 34) gave the United States Department of Agriculture (USDA) the power to regulate the Futures market.<sup>9</sup>

In 1936, Congress enacted the Commodity Exchange Act, which was enforced by the United States Department of Agriculture until 1974.<sup>10</sup> In the 1970's, futures contracts began expanding into non-agricultural markets such as metals, petroleum, financials, and currencies market. Therefore, Congress recommended that an all-purpose agency be created to oversee both the traditional and expanding non-agricultural commodities. This new agency was christened, the “Commodity Futures Trading Commission (CFTC)”.<sup>11</sup> The CFTC had to refrain from using the word “securities” which would set off alarm bells at the Securities Exchange Commission which was very eager to regulate these emerging financial products.<sup>12</sup>

After the CFTC came into existence in 1974, the issue of its jurisdiction was quickly challenged.<sup>13</sup> Later, the CFTC's jurisdiction was found to extend to interstate commodities transactions and thus the rules of other agencies did not apply.<sup>14</sup> *Trustman v. Merrill, Lynch, Pierce, Fenner & Smith* (CD Cal. Jan, 1985).

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<sup>8</sup> William D. Falloon, *Market Maker: A Sesquicentennial Look at the Chicago Board of Trade* 157-158 (Board of Trade of the City of Chicago 1998)

<sup>9</sup> *Id.*

<sup>10</sup> See [www.futuresindustry.org/regulato-2224.asp](http://www.futuresindustry.org/regulato-2224.asp) Oct 27 2004.

<sup>11</sup> William D. Falloon, *Market Maker: A Sesquicentennial Look at the Chicago Board of Trade* 246-247 (Board of Trade of the City of Chicago 1998)

<sup>12</sup> *Id.* At 247

<sup>13</sup> *State of Texas v. Monex International Ltd.* (Tex.Ct.Civ App. 1975).

<sup>14</sup> *Trustman v. Merrill, Lynch, Pierce, Fenner & Smith* (CD Cal. Jan, 1985).

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In 1981, the CFTC gave its approval for the National Futures Association (NFA) to become the self-regulatory organization (SRO) for the futures industry.<sup>15</sup> Unlike the NASD, the National Futures Association is not affiliated with any one marketplace. The NFA performs several regulatory activities such as (1) auditing members to enforce compliance with NFA financial requirements; (2) establishing and enforcing rules and standards for customer protection; (3) conducting arbitration of futures-related disputes; and (4) performing screening to determine fitness to become or remain an NFA member.<sup>16</sup> The NFA is responsible for regulating Futures Commission Merchants (FCMs), Introducing Brokers (IBs), Commodity Trading Advisors (CTAs), and Commodity Pool Operators (CPO's).<sup>17</sup>

In the 1990's, the Chicago Futures Markets challenged the Over-the-Counter (OTC) market in order to prevent them from developing *off-exchange* electronic trading platforms.<sup>18</sup>

### III. BASIC RISK MANAGEMENT STRATEGIES FOR HEDGERS<sup>19</sup>

Risk Management has become the new buzz word for "Hedging", yet both these terms are still used interchangeably. Typically a "Hedger" is a person or entity that takes a Futures or Options position that "offsets" a risk in a concurrent "cash" market position. For

example, a natural gas producer (who has gas production coming in from wells each month) could take a Futures or Option position (or a combination of both) that would provide price protection should the market decline. In market jargon, we would say that the gas producer is "*long* the cash" and therefore would need to "*short* the futures market" to shift his price risk exposure onto the Futures Market. Notice how the price risk in the *long cash* is offset by the *short futures*, thus a "Short Hedge" occurs. Of course, the Hedger determines when to hedge, the percentage to hedge, the strategy, the timing, and selects from multiple strategies (each with differing levels of risk, reward, and margin requirements).

However, some smaller producers are not offensive in their trading programs but look at risk management from a more "defensive" perspective. In the Futures markets, *fear* drives many of the market participants (including Hedgers) into various trading situations, whether it is a fear of lower prices (thus prematurely *entering* new short positions) or a fear that margin calls will become too excessive to meet (thus *avoiding* the futures completely and just selling the cash product instead). Yet, while many panic during times of extreme market volatility, some of the larger firms are poised to capitalize on these opportunities as they stand ready to provide liquidity to the market during temporary periods of high volatility.<sup>20</sup>

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<sup>15</sup> National Futures Association Manual, 1003 (January 2003).

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> *Board of Trade of the City of Chicago v. Securities and Exchange Commission*, 923 F.2d 1270 (7<sup>th</sup> Cir. 1991).

<sup>19</sup> Kurtis Ward, *Cattle Market of 2003-Risk Management Strategies for 2004* (Oklahoma Cowman 2004).

<sup>20</sup> Interview with Aubrey K. McClendon, Chairman and Chief Executive Officer, Chesapeake Energy Corporation (CHK), [www.chkenergy.com](http://www.chkenergy.com) (April 28, 2004).

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An entity that has negative price risk exposure if the underlying commodity rises, would be called a “Long” Hedger. To review, an entity that needs to avoid or minimize price declines, would be called a “Short Hedger”, while one who seeks to avoid or minimize price increases, would be called a “Long Hedger”. Even though the combinations of possible strategies are endless, there are several common risk management strategies used by all Hedgers today. This article will discuss several of these basic risk management strategies from the view point of a “Short Hedger” who needs price protection from a declining market.<sup>21</sup>

**SPECULATE ON CASH MARKET:**

This first strategy is not really a strategy at all (although it could be viewed as the default strategy of doing nothing). Some commodity producers (who refuse to hedge) say that since they are always selling cash production at regular intervals, they will sometimes sell at market highs, sometimes sell at market lows, and sometimes sell in between. Therefore, they argue that the prices they receive throughout the year should average out in the end. Unfortunately, it was the failure of this strategy (letting the market dictate the price received at time of sale) that served as the catalyst for the development of cash forward contracts and subsequently Futures contracts that would allow producers to make pricing decisions well in advance of selling the underlying cash commodity.<sup>22</sup>

**CASH FORWARD CONTRACT:**

The result of a CASH FORWARD CONTRACT by itself is almost identical to the result of a STRAIGHT HEDGE BY SELLING FUTURES. The difference is that with a Cash Forward Contract, there is usually no initial margin deposit or subsequent margin calls made by the producer. If the market moves higher after the forward contract is in place, the result is the same had margin calls been made anyway because there is no ability to participate in a higher market if prices rise after entering into a cash forward contract. Cash contracts are usually quoted lower than the prevailing Futures Market price because the entity making the cash contract available to a producer needs to receive some profit for “making a market” in the forward pricing of the cash commodity. In a scenario where the market price drops precipitously, one of the major concerns with a cash contract is *CounterParty Risk*. This is a term which defines the *risk of default* if the market drops so much that the other party doesn’t show up in the end to fulfill its end of the contract (i.e. receiving the cash commodity in exchange and paying the producer the agreed price). This happened to many producers in the energy industry in their dealings with Enron. Enron had many ventures, one of which was cash forward contracting with oil and gas producers. When Enron collapsed, it defaulted on many of its cash contracts. When one party to a Cash Forward contract defaults, the other party with damages will need to seek legal representation.<sup>23</sup>

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<sup>21</sup> Kurtis Ward, *Cattle Market of 2003-Risk Management Strategies for 2004* (Oklahoma Cowman 2004).

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

**BUYING CALL OPTIONS WITH CASH FORWARD CONTRACT:**

Producers who enter into cash contracts and are willing to take the counterparty default risks should consider simultaneously BUYING CALL OPTIONS in order to participate should the underlying price of the commodity rise. The cash contract itself provides the unlimited downside price protection. If the Call Option is also bought, the hedger will still be able to participate should the market keep moving higher. The hedger will pay a premium for this Call Option, but the loss from the option will be limited to its initial cost. The Call Option will provide unlimited profit potential at the strike price and above (minus the cost of the option).<sup>24</sup>

**BUYING PUT OPTIONS:**

Buying Put Options is one of the most basic foundational hedging strategies and essential for any risk management program. Buying a Put allows a “floor price” to be set in at the selected strike price while still allowing one to participate if the market moves higher (unlike the Cash Contract or Straight Futures Hedge). Buying a Put is a one-time expense which means the initial cost of the option is the only financial obligation. There will be no further margin calls when an option alone is purchased. There are several strike prices available on each contract month. The closer the strike price is to the underlying futures contract, the more an option will cost. The “floor price” gives the Put buyer unlimited profit potential at the strike price and below, while the maximum loss from the strategy cannot be more than the initial cost of the option. Some Hedgers buy cheap Put Options at their break-even-price to simply “hold their money together”. This strategy

usually complies with a bank’s lending agreement, which requires their borrower to use some form of risk management.<sup>25</sup>

**STRAIGHT HEDGE BY SELLING FUTURES CONTRACT:**

When Selling the Futures, the Futures Price is locked in. Margin money must be deposited with the broker. This margin money is earnest money (good faith funds) that will be used to offset any losses in the account should the market keep rising. There is *unlimited risk if the market rises* and the position is subject to on-going margin calls that must be immediately met to keep the positions from being liquidated by the brokerage firm. There is also *unlimited profit potential to the downside in a declining market*. If the market drops, money immediately flows into the futures account even before the position is offset. There is virtually no Counter-Party Risk because the exchange is the other party to the transaction, not some person or small corporation like in a cash forward contract. Basically, Futures are really “exchanged traded forward contracts” that have been standardized so that all terms (contract size, grade, delivery, etc) are uniform and disclosed to all market participants. The Futures market gains or losses are then either credited or debited to the concurrent cash market transaction to complete the analysis of this risk management strategy.<sup>26</sup>

**THE WINDOW/FENCE: (BUYING PUTS / SELLING CALLS):**

This strategy is rather complicated and is not suitable for the first time hedger. Basically, a floor price is set in at the strike price where the Put is bought. This strategy also requires that a “ceiling price” be set in somewhere

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<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

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above the current futures price which is done by Selling a Call. The advantage is the market will pay back some premium for setting in the "ceiling price" and this premium can be used to offset some of the purchase price of the Put. Because there is extra premium obtained from Selling the Call, a higher strike price on the Put might become more affordable when using this strategy. Experienced hedgers use this strategy to set in a higher floor price because the Call that is sold offsets much of the cost of the Put. Because of the "ceiling price" created from Selling the Call, initial margin money is also required (in addition to the cost of the Put). There is now unlimited risk above the Call strike price and additional margin calls will be required if the market moves higher.<sup>27</sup>

**COSTLESS COLLARS (another type of WINDOW/FENCE):**

The Call Option that is sold is at or near the same price as the Put Option that is bought. Thus, the price of the protection nets out near \$0 (zero dollars). Margin money for Selling the Call is also required as well as the potential for additional margin calls. As the name "costless" implies, as long as the Futures Price stays below the strike price of the Call, the protection in the end will cost almost nothing and will still provide unlimited downside protection at the strike price of the Put.<sup>28</sup>

**THE BUTTERFLY: (Another type of WINDOW/FENCE with a twist):**

The Butterfly starts out as a Window/Fence except that another Put is also sold several strike prices below the first Put Option that

was bought. Selling this other Put is the extra twist because it cheapens up the cost of the Window because more premium is received from the additional Put that is sold. Profit potential is no longer unlimited to the downside but is now limited to the difference between the two strike prices of the Put Options (less their net cost). In a steep drop in prices, the profit potential from this risk management strategy is limited.<sup>29</sup>

**PUT SPREAD: (BUYING A PUT / SELLING A PUT):**

Basically it is the Butterfly above without the Ceiling Price since no Call Option is sold. If the Cash and Futures Market moves higher, there is full participation to the upside and no margin calls. To the downside, the most that can be made is the difference between the strike prices of the two puts (less the net cost). It is a one-time expense and there is no subsequent margin calls. This strategy may be appropriate when volatility levels are such that the options seem too expensive but some protection is still desirable. In a market crash, the profit potential from this strategy is also limited.<sup>30</sup>

**SYNTHETIC PUTS: (SELLING FUTURES / BUYING CALLS):**

This complex hedging strategy works very similar to the simple strategy of just buying a Put but has much more flexibility. The traditional Put Option allows the buyer to pay a premium for a certain strike price, which provides unlimited protection at the selected strike price. In the Synthetic Put, the Futures are sold (for the downside protection) and a Call option is bought to keep losses from the

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<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

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futures predetermined should the market continue to rally. For advanced hedging programs, this strategy provides some the greatest flexibility because either side of the position could be liquidated in some profitable situations (but doing so will of course change the risk structure of the entire hedge).

One of the drawbacks of Synthetic strategies is that they have the largest requirements for initial margin money since the option that is purchased must be fully paid for and the margin for the entire futures position must be met as well. When the futures position is losing large amounts of money, those margin calls must be met even though the option may be absorbing most of the loss. This anomaly is possible because gains in option value due to market appreciation (unlike futures) cannot be used for margin purposes. Even though the option may be shielding actual losses from the futures position, the gain in value from the option cannot be *realized* until it is liquidated. Experienced risk managers realize that even if they are forced to send in additional margin funds during the time of this synthetic strategy, once the option is liquidated, those extra margin calls will be returned.<sup>31</sup>

**SUMMARY OF RISK MANAGEMENT STRATEGIES:**

For all commodities, futures, and derivatives, a risk management program is essential for any entity's long-term survival. It does not matter much if the hedging plan is simple, moderately advanced, or extremely complex. For best results, top risk managers combine several of these hedging strategies rather

than focusing on just one, realizing these strategies are tools for transferring price risk from the cash market onto the Futures market (each with different levels of risk and reward) all working together to minimize price risk and insure long-term financial viability.<sup>32</sup>

**IV. DERIVATIVES, SWAPS,  
CONTROVERSIES, COURTS & CONGRESS**

Commodity cash forward contracts were the predecessors of what became a sophisticated collage of Futures contracts which now trade on Commodity Exchanges around the world. It could be said that Futures and Options were "*derived*" from the underlying cash commodity from which they were created to emulate. Over the past two decades, large market participants (particularly banking institutions) have financially cloned Futures & Options, thereby creating a new class of innovative financial contracts called "Derivatives". These *off-exchange traded* Derivatives primarily exist on the Over-the-Counter Market (OTC).<sup>33</sup> The OTC Market is a non-regulated market consisting of mostly large banks and institutional clients where trades are conducted privately over the phone or through computer networks and not on an Exchange.<sup>34</sup>

It is quite common after an institution books an *off-exchange* Derivative contract with a counterparty for it to simultaneously lay off that same risk in an offsetting transaction on a U.S. Exchange using an *exchange traded* Futures or Options contract. This dual function trading activity is called "arbitrage" whereby market players look for inefficiencies in either market and then take offsetting

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<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> Philip McBride Johnson, *Derivatives* 33 (McGraw-Hill 1999).

<sup>34</sup> *Id.*

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trades, pulling out small amounts of profits in the process.<sup>35</sup> Because of the leverage available in Futures and Derivatives contracts, those small profits can become quite substantial because the “notional value” is so large (notional value is the size of the contract agreed upon by the parties).<sup>36</sup> *Notional value* of a Derivatives transaction is synonymous to the *contract size* of an exchange traded Futures contract.

Another arbitrage play (where banks are making enormous profits) occurs where a financial institution enters into a Derivative contract with one of its customers, thereby taking the opposite side of the client’s position. The client is allowed to place the Derivative trade without posting any additional margin funds because the financial institution already has a loan with the client (or a sufficient amount of collateral has already been deposited). This seems attractive to the client because (if approved) trades can be executed without posting additional margin funds.

The Over-the-Counter (OTC) market is the virtual exchange used for the trading of securities, futures, options, swaps, and other

Derivatives transactions that do not take place on an exchange but rather trade *off exchange* between financial institutions and large institutional clients.<sup>37</sup> There are several types of Derivative contracts but the “Swap” and “Hybrid” are the most common.<sup>38</sup>

According to the Bank for International Settlements, the amount of Outstanding OTC Derivatives around the world was valued at \$US 127 trillion as of June 2002.<sup>39</sup> Interest Rates overwhelming represent the bulk of Derivatives transactions (mostly Swaps) and comprise about 70% of that total while Foreign Currency Exchange is a distant second with only 14% of the market share.<sup>40</sup> In comparison, Futures traded on organized exchanges around the world is much smaller (\$US 23 trillion).<sup>41</sup> When looking at the Futures/Derivatives Industry as a whole, the contracts traded *off-exchange* represent more than 80% of the industry while exchange traded contracts represent 20%.<sup>42</sup> Some leaders within the Futures Industry believe the total amount of Futures/Derivatives world-wide has grown to \$200 trillion in 2003 but that the exchange traded contracts have recently grown at a more rapid rate and now compose 1/3 or 33% of the total outstanding value.<sup>43</sup>

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<sup>35</sup> Vinod Kothari, *Credit Derivatives and Synthetic Securitization* 165 (Academy of Financial Services 2002).

<sup>36</sup> Philip McBride Johnson, *Derivatives* 10 (McGraw-Hill 1999).

<sup>37</sup> Philip McBride Johnson, *Derivatives* 33 (McGraw-Hill 1999).

<sup>38</sup> *Id.*

<sup>39</sup> Desmond MacRae, *Innovations in Disaster*, *Stock, Futures & Options*, 30, 32 (June 2003).

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> Russell Wasendorf, Sr., *Innovation Deserves More than 15 Minutes of Fame*, *Stocks, Futures & Options Magazine*, 21, 117 (June 2003).

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Swaps are the predominant type of Derivatives contract. A swap is an OTC transaction where two parties agree to exchange payment streams (one person wins the other person loses) based on a specific “notional amount” (similar to contract value) for a specified period.<sup>44</sup> The notional amount of a swap is the underlying principal amount in which some calculation is based depending on whether the underlying contract is an interest rate, foreign currency exchange, stock index, gold, or energy contract.<sup>45</sup> Typically, there is a settlement day on the last day of the contract where the loser must pay the winner based on where the underlying market closed on the last day of the Derivative contract.

Credit Derivatives are one of the more recent innovations that allow one party, the beneficiary, to transfer credit risk of a “reference asset” (which may or may not be owned by the party) to another party who is called the “guarantor”.<sup>46</sup> This allows the guarantor to assume the credit risk associated with the asset without directly purchasing it either.<sup>47</sup> Both sides of this transaction are analogous to an Option where a purchaser pays a premium to the seller for price protection on an underlying asset.

Since trading in Derivatives requires large amounts of capital, it is primarily the playing field of large corporations, governments,

hedge funds (a hedge fund is really a speculative fund and only *hedges* to the extent as an arbitrager)<sup>48</sup> banks and other financial institutions.

Portfolio managers, who want to be free from most of the regulations imposed by the SEC and the CFTC, organize what is called a *hedge fund*.<sup>49</sup> A Hedge Fund is a trading entity formed as a limited partnership where the limited partners are the investors.<sup>50</sup> These limited partners contribute money to the portfolio and the general partners manage the portfolio. Typically, the hedge fund investor must invest \$1 million or have a net worth of \$5 million. Since the hedge fund is only made up of “wealthy people”, the SEC does not feel they need to monitor them like other mutual funds made up of many small investors (although this view is changing). A hedge fund usually takes large risks. Therefore, Futures, Options, and Derivatives play a big role in their portfolios.<sup>51</sup>

**Alan Greenspan and Warren Buffet  
opposing views on Derivatives contracts**

Depending on the market guru, Derivatives are either a “Dr. Jekyll or Mr. Hyde”. For example, Federal Reserve Chairman, Alan Greenspan, has been the most influential advocate of Derivatives.

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<sup>44</sup> Philip McBride Johnson, *Derivatives* 203 (McGraw-Hill 1999).

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> John R. Nofsinger, *Investment Blunders of the Rich and Famous* 198 (Financial Times Prentice Hall 2002).

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

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Derivatives have their famous detractors as well. Warren Buffet paints a picture of an imminent financial Armageddon. In Berkshire Hathaway's annual report for 2002, Mr. Buffet wrote:

"Derivatives are financial weapons of mass destruction, carrying dangers that while now latent, are potentially lethal..."<sup>52</sup>

The purposes and ideals advocated by Chairman Greenspan suggest that Derivatives do have a place in our financial markets. Yet, Mr. Buffet's cataclysmic warning about Derivatives goes to the heart of their "double-edge sword" characteristic (with high return comes very high risk) as evidenced from the enormous losses suffered by the following institutions in their Derivatives trading programs.

**Proctor & Gamble (lost \$200 million in 1994).**

Derivatives (like Futures) would also face a judicial determination whether they met the definition of a security under the Supreme Court's "Howey test". *Proctor & Gamble Co., v. Bankers Trust*, 925 F. Supp. 1270 (S.D. Ohio 1996). Bankers Trust, a Broker Dealer and Derivatives firm, entered into an Interest Rate and Currency Swap transactions with

Proctor & Gamble (P&G), a publicly traded company.<sup>53</sup> These swap agreements were originally negotiated in late 1993 and early 1994.<sup>54</sup> During the preceding year, interest rates in both the United States and Germany moved substantially higher which resulted in huge losses for P&G. The counterparty to the transaction, Bankers Trust, claimed that they were owed over \$200 million on the two swaps.<sup>55</sup> P&G claimed that since it was fraudulently induced into these transactions and because the swaps were fraudulently executed, P&G should owe nothing to Bankers Trust.<sup>56</sup> Furthermore, P&G alleged fraud, misrepresentation, breach of fiduciary duty, negligent misrepresentation, negligence, violations of the Securities Acts of 1993 and 1934, the Commodity Exchange Act, Section 10(b) of the Exchange Act of 1934 and Rule 10b-5, as well as several Ohio state laws.<sup>57</sup>

This was a novel case because it involved questions of first impression whether swap agreements would fall within federal securities laws, commodities laws, or Ohio Blue Sky state laws.<sup>58</sup> The court held that the swap agreements *were not securities* as defined by the Securities Acts of 1933 and 1934 and the Ohio Blue Sky laws and that these swap agreements *were exempt* from the Commodity Exchange Act.<sup>59</sup>

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<sup>52</sup> See Berkshire Hathaway's annual report [www.berkshirehathaway.com/2002ar/2002ar.pdf](http://www.berkshirehathaway.com/2002ar/2002ar.pdf).

<sup>53</sup> *Proctor & Gamble Co., v. Bankers Trust*, 925 F. Supp. 1270, 1276 (S.D. Ohio 1996).

<sup>54</sup> *Id.*

<sup>55</sup> *Id.* at 1277.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.* at 1274.

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

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Bankers Trust argued that swaps were not investment contracts because neither parties to the swap “invested any money”, rather they agreed to exchange cash payments at a date in the future.<sup>60</sup> The swaps did not involve an investment in a “common enterprise” which entails pooling funds for the purpose of a business venture.<sup>61</sup> Bankers Trust argued the gains from the swaps were “not profits derived from managerial or entrepreneurial efforts of others” but were payments to be made to either party of the transaction according to future changes in U.S. and German interest rates.<sup>62</sup> While the court stated that swaps may meet some of the elements of the Howey test, the missing element was “*the lack of a common enterprise*” as P&G did not pool its money with that of any company nor did it join together in a common venture with Bankers Trust.<sup>63</sup> The court found that P&G was counterparty with Bankers Trust and therefore they could not be lumped together as a “common enterprise.”<sup>64</sup> Since Bankers Trust was not managing P&G’s money and the value of the swaps depended on market forces and not Bankers Trust’s entrepreneurial efforts, the swaps were not investment contracts.<sup>65</sup> The court went on to hold that neither were the swaps *notes* as they failed to

meet all of the prongs of the “Reves Family Resemblance test”.<sup>66</sup> Therefore, the swaps would not fall under the purview of the Securities Acts of 1933 and 1934.<sup>67</sup>

The court stated it did not decide the issue *if swaps were futures contracts* because P&G failed to state a claim under this issue. It commented how as of January 1996, the CFTC had not taken a position whether swap agreements were futures contracts even though it had been granted authority under Title V of the Futures Trading Practices Act of 1992 to exempt certain swaps transactions from the Commodity Exchange Act (CEA) coverage under 7 U.S.C. §6(c)(5).<sup>68</sup> Even if the swaps were exempt from other provisions of the CEA, they would still be subject to its anti-fraud provisions.<sup>69</sup>

**Orange County, CA (bankrupt after \$1.7 billion loss in 1994).**

One of the alarm bells that should send investors running for cover is when a portfolio manager tells investors, “*don’t worry...these are just paper losses*”. Robert Citron was a county treasurer whose Derivatives investments lost \$1.7 billion in 1994 and

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<sup>60</sup> *Id.* at 1278.

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> *Reves v. Ernst & Young*, 494 U.S. 56, 64-67, 110 S. Ct. 945, 108 L. Ed. 2d 47 (1990).

<sup>67</sup> *Proctor & Gamble Co., v. Bankers Trust*, at 1278.

<sup>68</sup> *Id.* at 1284-1285.

<sup>69</sup> *Id.*

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caused Orange County to become the largest municipal failure in history.<sup>70</sup> In the 1980's, Robert Citron's return on Orange County's portfolio outperformed other treasurers, including the state fund. How? He did it by investing in riskier securities. The higher returns led many cities, agencies, and school districts to put their money in the Orange County fund. When the fund collapsed, 185 cities and other agencies had contributed a total of \$7.6 billion into the pool. By taking money it was borrowing from reverse-repo transactions and buying more Treasury securities, Orange County was able to purchase \$20 billion worth of securities for a portfolio that only had \$7.6 billion in equity.<sup>71</sup>

In the years that led up to 1994, interest rates continued to decline, which was good news for Orange County's leveraged bond portfolio which outperformed its peers. During 1994, the Fed increased short-term interest rates six times from 3.0% to 5.5%, catching many bond investors by surprise. Higher interest rates caused the value of bonds to fall. The leveraged portfolio only magnified the losses. In September, Citron called the losses just "paper losses", but by December, Orange County publicly announced the loss which had grown to \$1.5 billion. Citron was forced to resign; he pleaded guilty to six counts of securities fraud and mismanagement, was fined \$100,000 and was sentenced to one

year in jail.<sup>72</sup>

**Barings Bank (bankrupt after \$1.1 billion in trading losses in 1995).**

In 1995, it was discovered that arbitrage trader Nickolas Leeson racked up losses in excess of \$1 billion, bankrupt the 223-year-old Barings Bank of London.<sup>73</sup> Nick Leeson ran an arbitrage trading desk for the bank. Barings Bank had access to the SIMEX Futures Exchange as well as Derivatives markets in both Singapore and Osaka, Japan.<sup>74</sup> Instead of booking trades for Barings' clients and performing arbitrage activities to lock in small trading profits, on his last day of work, Nick Leeson had accumulated 61,039 Nikkei Futures Contracts, 26,000 Japanese Bond Futures, and a huge stock option straddle position (all of which were losing millions of dollars).<sup>75</sup> Not only did Nick guess wrong on all three positions (and continue to add to those losing positions), but unfortunately for Barings Bank, he also had access to back office records allowing him to cover up the trading losses for over two years.<sup>76</sup> The total loss was over \$1 billion.<sup>77</sup>

**Long-Term Capital Management (lost \$4.5 billion in 1998 and Federal Reserve led a Wall Street bailout to avert a financial crisis).**

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<sup>70</sup> John R. Nofsinger, *Investment Blunders of the Rich and Famous* 213-241 (Financial Times Prentice Hall 2002).

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* at 227.

<sup>73</sup> *Id.* at 233-241.

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

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John Meriwether, Larry Hilibrand, and two Nobel Prize economists, Merton Miller and Myron Scholes, helped found Long-Term Capital Management (LTCM) in 1993.<sup>78</sup> Initially, \$1.25 billion of capital was raised for the fund, but more would come later. Prior to LTCM, Myron Scholes achieved fame for his contribution to the “Black-Scholes Option Pricing Theory”, in which mathematical equations were created to value market price behavior.<sup>79</sup> LTCM used this theory to value Derivatives transactions in a variety of markets, especially bonds. As an aggressive Hedge Fund, LTCM became famous as it invested in Derivatives and other highly leveraged speculative strategies with the objective of taking advantage of market irregularities. At its peak, a \$1,000 initial investment in LTCM would have grown to \$4,000 in just four years. *It took just five weeks for LTCM to lose over \$4 billion.*<sup>80</sup>

**“The fund (LTCM) had entered into thousands of Derivative contracts, which had endlessly intertwined it with every bank on Wall Street. These contracts, essentially side bets on market prices, covered an astronomical sum – more than \$1 trillion worth of market exposure”.**<sup>81</sup>

In September 1998, the Federal Reserve orchestrated a \$3.65 billion bailout of LTCM

which included 14 Wall Street banks<sup>82</sup> (most of them were LTCM’s counterparties on many of these trades). The Fed was extremely concerned as several large financial institutions had entered into swap contracts with LTCM. Severe market repercussions were expected to follow if LTCM defaulted on its swaps, which some suggested would send shockwaves throughout the entire financial markets.<sup>83</sup>

**Enron (Derivatives losses and off-balance-sheet fraud discovered in 2001 leads to a \$1.2 billion reduction of equity and ultimate bankruptcy for the largest energy and derivatives trading firm in the world).**<sup>84</sup>

Off-balance-sheet assets and Special Purpose Entities (Enron’s SPE’s were called Raptors) were used to “cook the books” at Enron to disguise transactions and hide losses from shareholders.<sup>85</sup> In response to Enron’s fraud, the Sarbanes-Oxley Act of 2002 was overwhelming passed by Congress, setting new requirements for publicly traded companies in the areas of Accounting, Securities, and Corporate Governance. The stated purpose of Sarbanes-Oxley is “to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws and for other purposes”.<sup>86</sup>

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<sup>78</sup> *Id.* at 194.

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *Id.* at 209.

<sup>83</sup> *Id.*

<sup>84</sup> Peter Fusaro & Ross Miller, *What Went Wrong At Enron* 176 (John Wiley & Sons 2002).

<sup>85</sup> *Id.* at 173.

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It all began in 1984 when a small energy company called Houston Natural Gas would eventually transform itself into a giant trading company that became known as Enron.<sup>87</sup> Enron became involved in almost every new market that came along, including Derivatives. Not only was Enron a player in energy Derivatives, but it extended its energy trading model to Weather Derivatives and Internet Bandwidth Derivatives.<sup>88</sup> By 1999, Enron's internet trading platform became the world's largest business-to-business platform averaging 6,000 trades per day worth \$2.5 billion.<sup>89</sup>

At the heart of Enron's controversy and fraud were its Derivatives transactions, which it entered into with several Raptor's (SPE's), which totaled over \$1.5 billion. Basically, Enron booked over \$500 million in income from these Derivatives transactions. The Raptor's lacked sufficient credit capacity to pay Enron on its hedges as Sherron Watkins (an Enron accountant) soon discovered. In Watkins' anonymous (but now infamous) memo, she methodically linked Enron's woes to its Derivatives (swaps) transactions.<sup>89</sup>

**“We (Enron) recognized over \$550 million of fair value gains on stocks via our swaps with Raptor, much of that**

**stock has declined significantly.....The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses.....It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.....the equity holders have no skin in the game, and all the value in the entities comes from the underlying value of the derivatives, unfortunately in this case, a big loss.....Looking at the stock we swapped, I also don't believe any other company would have entered into the equity derivative transactions with us at the same prices or without substantial premiums from Enron. Raptor looks to be a big bet, if the underlying stock did well, then no one would be the wiser. If Enron stock did well, the stock issuance to these entities would decline and the transactions would be less noticeable.”<sup>91</sup>**

Enron's bankruptcy was the largest in U.S. history at that time.<sup>92</sup> At its peak, Enron reached over \$90 per share in August 2000.<sup>93</sup> By December of 2001, the stock price would be worthless.<sup>94</sup> The Natural Gas and Crude Oil Futures also dropped severely during this

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<sup>86</sup> See Sarbanes-Oxley Act of 2002.

<sup>87</sup> Peter Fusaro & Ross Miller, *What Went Wrong At Enron 4* (John Wiley & Sons 2002).

<sup>88</sup> *Id.* at 66-67.

<sup>89</sup> Peter Fusaro & Ross Miller, *What Went Wrong At Enron 171* (John Wiley & Sons 2002).

<sup>90</sup> *Id.* at 185.

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> *Id.* at 110.

<sup>94</sup> *Id.* at 178.

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same time period, which caused oil and gas companies who contracted with Enron (instead of booking their trades through the Exchange) to lose millions of dollars when Enron defaulted on their contracts.

In January of 2002, Swiss-based Wall Street firm UBS Warburg (the last firm to downgrade Enron's stock) purchased Enron's energy trading business by beating out Citigroup.<sup>95</sup> Enron's energy trading business generated about 90% of the company's \$101 billion in revenue in 2000.<sup>96</sup> For this business, UBS Warburg paid \$0 upfront (that's right, zero dollars) and agreed to pay Enron and its creditors 33% of the pre-tax profits for two years with an option of buying Enron's stake in subsequent years.<sup>97</sup>

## CONCLUSION

When the Securities Act of 1933 was enacted just within a few weeks of Franklin D. Roosevelt taking office, it was the first time national securities legislation had ever been passed by Congress.<sup>98</sup> In his inaugural address, Roosevelt announced that "*the money changers have fled from their high seats in the temple of our civilization*"<sup>99</sup> (which was a symbolic reference to Jesus casting out the moneychangers from the temple).<sup>100</sup> Later that spring, the Glass-Steagall Act of 1933

(also called the Banking Act) would radically alter the face of banking by creating deposit insurance and separating investment and commercial banking.<sup>101</sup> However, some sixty years later, the Gramm-Leach-Bliley Act would repeal many restrictions contained in the Glass-Steagall Act, which left some wondering if the moneychangers had indeed returned to Wall Street's temple. Derivatives (as we know them today) were not in existence in the 1930's. Nevertheless, the fact that Gramm-Leach-Bliley Act and the Commodity Futures Modernization Act of 2000 inserted exemptions for Swap Agreements directly into the Securities Act of 1933 suggests how influential the banking lobby had become.<sup>102</sup>

Even though Derivatives received favorable treatment in *Proctor & Gamble v. Bankers Trust*, as well as special exemptions from the CFTC, the Gramm-Leach-Bliley Act, and the Commodity Futures Modernization Act of 2000, it is probable that Derivatives litigation will increase in the future due to the enormous financial losses associated with these colossal-sized transactions. To some it may appear (because of the large dollar amounts involved), that Derivatives losses are outrageous and should be banned altogether. However, it should be noted that in the cases of fraud, financial losses are always

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<sup>95</sup> Houston Chronicle, *Swiss Bank to Pay Nothing Up Front for Enron's Trading Business*, (January 15, 2002).

<sup>96</sup> *Id.*

<sup>97</sup> *Id.*

<sup>98</sup> Charles R. Geist, *Wall Street-A History* 228-229 (Oxford University Press 1997).

<sup>99</sup> *Id.*

<sup>100</sup> John 2:15 (King James).

<sup>101</sup> Charles R. Geist, *Wall Street: A History* 230 (Oxford University Press 1997).

<sup>102</sup> §2(A) Securities Act of 1933.

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outrageous when illegal activity by one party causes monetary damages to another. The question is, do we really want federal regulators to limit a market participant's right to freedom of contract because one party "might guess wrong" and lose millions of dollars in a transaction? If both parties can financially assume the underlying inherent risks associated with Derivatives contracts (assuming they are made in compliance with full and fair disclosures), should we preclude their trading in the United States only to watch this business move overseas?<sup>103</sup>

These two issues (freedom of contract and overseas competition) may explain why Congress and the federal financial regulators have sought to keep OTC Derivatives exempt from scrutiny provided they remain the domain of institutions and not accessible to the investing public. The systemic risks that could potentially harm the world's financial system cannot be overlooked either. Perhaps the abuse of leverage is where regulators should focus their regulatory oversight by requiring some form of institutional margining of funds similar to the initial margin requirement system used by all Futures Exchanges. Yet, some would argue that this would simply turn OTC Derivatives back into exchange traded Futures contracts. Others point to a world organization already in place which is working to bring financial institutions together to insure uniformity and stability to the OTC Derivatives markets. That organization is called the International Swaps & Derivatives Association

(ISDA).<sup>104</sup>

The ISDA was founded in 1985 and has more than 600 members of which 202 are primary members representing the largest OTC Derivatives dealers.<sup>105</sup> According to the ISDA, less than one percent of all outstanding OTC Derivatives (\$127.6 trillion) are collateralized.<sup>106</sup> Since 1992, the ISDA requires transactions to be documented (in a "Master Agreement") between parties of different jurisdictions around the world and when transactions occur in different currencies.<sup>107</sup> This Master Agreement also standardizes damages provisions, close out provisions, force majeure termination events, interest, and compensation provisions between the parties and it is widely accepted by most Derivatives dealers around the world.<sup>108</sup>

While the court seemed unsympathetic to Proctor & Gamble's \$200 million dollar Derivatives loss, perhaps prospective entities who are harmed by these contracts might be able to prevail under other legal theories.<sup>109</sup> One phenomenon that has occurred after the passage of the Commodity Futures Modernization Act of 2000 is the number of new dealers entering into the OTC Derivatives markets. Mid-size Banks are likewise joining the Wall Street Banks and are jumping head first into Derivatives trading as a means to generate additional fees and create new profit centers by executing Derivatives transactions with their existing clients. Since the financial

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<sup>103</sup> Wall Street Journal, *Derivatives Growth has Helped Banks*, (October 8, 2002).

<sup>104</sup> See <http://www.isda.org/>

<sup>105</sup> Desmond MacRae, *Innovations in Disaster*, Stock, Futures & Options, 30, 33, (June 2003).

<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> *Proctor & Gamble Co., v. Bankers Trust*, at 1278.

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institution already has the customer's loan or investment banking business, it is a rather easy task to persuade (or demand) their client to use their new "in-house trading services". One inducement for the client (which is different from exchange traded products) is that margin funds do not have to be directly posted for Derivatives trades with the bank (although market fluctuations of the Derivatives will be assessed internally against lines of credit). Regardless of the marketing spin, *there is no free lunch*.

Since in many cases the bank already has a loan with the client, it can easily evaluate counterparty risk of the client by using credit information already in its possession (from a prior fiduciary purpose). If the client enters into Derivatives trades with the bank, the client's available collateral and equity will be closely monitored at all times, especially when the market moves against the client. Here lies the quandary. At what point does the financial institution breach fiduciary duties owed to the client when it switches roles from a fiduciary to a counterparty? What will the ramifications be after the client loses large amounts of capital through Derivatives losses (paid from the client directly to the bank) if the bank uses its existing relationship without a good faith and fair disclosure to the client (or uses undue influence) of all the important details of this new trading relationship (i.e. transaction fees, hidden costs, wider bid/ask spreads,

increased interest costs, leverage risks, conflicts of interests, etc.)?

Banks and other financial institutions may become over confident if they rely too much on the *Proctor & Gamble* decision and recent legislation. They may be surprised to discover how their behavior was found to be culpable after all (based on other legal theories) and thus held financially responsible for the OTC Derivatives losses of their clients even though they alleged these were just "arms-length transactions".

The client not only runs the risk of its fiduciary becoming an adversarial counterparty but the client may be unknowingly booking *off-exchange* trades with the next LTCM or Enron. Finally, if Warren Buffet is right, unconstrained Derivatives trading might be the catalyst which causes the entire economic system to collapse in a financial holocaust. This warning reverberates in the closing words of a former Federal Reserve member who voices his consternation in his book about the impropriety of Securities & Derivatives Regulation. Martin Mayer writes, "*The tragedy for all of us would be if the Fed, the Treasury, and Congress's reverence for people who make a lot of money left us unprotected against some sudden revelation of the truth that becomes obvious only in hindsight, that a lot of them don't know what they're doing*".<sup>110</sup>

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<sup>110</sup> Martin Mayer, *The*