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# **Trading Risk: the Contractual Nature of Derivative Transactions and Certain Regulatory Issues**

**Chao-hung Chen**

Thesis submitted for the degree of Ph.D.  
University College London



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Chao-hung Chen

# Abstract

In this thesis, we explore the contractual nature of so-called “derivatives” and how they might be incorporated into existing legal concepts. This thesis takes the position that derivatives are in essence contracts to trade risk, and argues that commodity future delivery contracts fall within the legal meaning of “futures” if they are traded as notional transactions settled by cash. We also argue that derivative instruments and traditional gambling instruments are both aleatory in nature. The question then is: “How should we allocate the function between gambling and financial laws in order to control speculation?” Moreover, this thesis argues that derivative instruments in general are not traditional insurance policies. We find no convincing reason to see derivative instruments as another contract *uberrimae fidei* and to restrict the use of derivative instruments with an equivalent of the insurable interest test. However, whether a firm selling derivative instruments should be regulated (and furthermore, be regulated like insurance companies) may require further consideration. In addition, securities laws are constructed upon the special characteristic of “securities”, which is not shared by most derivatives. Caution is required when applying rules developed in securities regulation to derivative instruments. However, we also recognise the potential for problems with insider dealing and market abuse in the derivatives market such that regulators might have to intervene. In the end, although derivatives do not fit well in existing categories, this does not mean that we need a special set of derivative contract laws: derivative instruments are based on general contract law, and without more substance, any derivative contract law is meaningless.

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# Chapter 1 Introduction

In this thesis, we will examine what are generally called “derivatives”.<sup>1</sup> We will answer the questions “what is the contractual nature of so-called ‘derivative instruments’?” and “how could we fit them into the existing legal system?” As will be discussed further in Chapter 2, this thesis will adopt Henderson’s distinction that classifies derivatives into three groups: exchange-traded products, OTC products, and hybrid instruments.<sup>2</sup> As we explain below, derivative instruments serve a function similar to insurance, gambling and investment. They may exist in the form of a sale of goods contract or an existing type of capital market instrument (e.g. securities). Categorising a derivative instrument as one existing type of instrument may not only have regulatory implications but also raise the application of certain private law doctrines.

Therefore, a question arises: should we classify a derivative instrument as any existing type of contract? A natural response to questions regarding classification would start with definitional issues, and a large part of practitioners’ concerns may be resolved by making a proper distinction based on a conceptual definition. However, this still leaves us with an unanswered question: why do we have special regulatory or private law rules for certain types of transactions in the first instance? This represents how the present thesis will approach certain problems of classification. In short, we will examine the legal classification of modern derivative instruments.<sup>3</sup> In this thesis, we will focus on the two major functions of derivative instruments—hedging and

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<sup>1</sup> In general, derivatives may be defined as instruments the value of which depends upon the value of other assets. Das, *Derivative Products & Pricing*, at 4 (3rd ed. rev. edn, John Wiley & Sons, 2006). See also *infra* 2.2.2 for the meaning of “derivatives”.

<sup>2</sup> See *infra* 2.2.2.1.

<sup>3</sup> See *infra* 1.3.2 for the scope of this thesis.

speculation—and we will take derivative instruments as contracts to trade risks. From here, we will explore the contractual nature of derivative instruments and certain regulatory issues that are implied by the classification of contracts.

## 1.1 Five Angles for Analysing Derivatives

In the past two decades, the derivatives market has grown at an amazing speed. According to the International Swaps and Derivatives Association (ISDA), the outstanding notional amount of all interest rate swaps, currency swaps and interest rate options in the first half of 2007 was more than 347 trillion US dollars, in comparison with 1.654 trillion at the end of 1988.<sup>4</sup> The notional amount of credit derivatives reached 26 trillion US dollars by mid 2006, up from 17.1 trillion six months earlier.<sup>5</sup> Although derivative instruments are useful tools for hedging risk for market participants, derivatives have also been described as a financial “weapon of mass destruction”.<sup>6</sup> One commentator has called the derivatives market “Jurassic park”.<sup>7</sup> The use and misuse of derivative instruments has caused spectacular losses,<sup>8</sup> but no matter whether we like them or not, derivatives have become a force in the global market that we cannot ignore.

If we temporarily leave behind the entanglement of current laws, there are several fronts on which we could examine modern derivative instruments. First, we are faced with the transition from physical trading to notional trading. Some derivative transactions may lead to physical delivery, like commercial sales, but

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<sup>4</sup> See ISDA market survey from <<http://www.isda.org/statistics/pdf/ISDA-Market-Survey-historical-data.pdf>> (visited on 18 January 2008).

<sup>5</sup> See ISDA Press release on 19 September 2006 from <<http://www.isda.org/>> (visited on 4 October 2006).

<sup>6</sup> See for example, “Buffet warns on investment ‘time bomb’”, BBC (4 March 2003), from <<http://news.bbc.co.uk/1/hi/business/2817995.stm>> (visited on 6 October 2006). Also quoted in Henderson, Henderson on Derivatives, at 1.1, note 3 (LexisNexis Butterworths, 2003).

<sup>7</sup> Hu, “Hedging Expectations: “Derivative Reality” and the Law and Finance of the Corporate Objective” (1995) 73 Tex L Rev 985, at 989.

<sup>8</sup> The best-known case is probably the Barings Bank scandal from the mid-1990s. Other famous victims include Orange County, Gibson Greeting, Procter & Gamble, etc. See Cohen, “Financial Services Regulation: A Mid-Decade Review: Colloquium: The Challenge of Derivatives” (1995) 63 Fordham L Rev 1993, at 1994-1996; Maready, “Regulating for Disaster: Federal Attempts to Control the Derivatives Market” (1996) 31 Wake Forest L Rev 885, at 887-888 (the Orange County scandal).

most result in cash settlement. Some underlying assets, like corn, may be deliverable but some, like indices, are not. Some commodities are deliverable, but the contract specifically allows cash settlement only (e.g. Brent oil futures). Derivative transactions originated from physical commodities trading, but many of them have become only notional—an exchange of cash.

Secondly, while a derivative transaction might be carried out entirely for commercial or financial purposes, it might bear no relationship to other business transactions. Derivative instruments are frequently used to hedge against market or credit risk, yet this does not hide the fact that a derivative transaction could be intended purely for speculation, a conduct that may be seen as no different from gambling.<sup>9</sup>

Thirdly, there is the transition from non-standardised transactions toward standardised trading. The futures market provides an ultra-standardised trading platform. Nonetheless, we should not ignore the possibility of totally individualised and privately negotiated derivative transactions.

Fourthly, there is the contrast between regulated contracts and unregulated instruments. While exchange trading is regulated in both the UK and the US, the status of certain off-exchange contracts is not very clear.<sup>10</sup> Nonetheless, regulated or not, derivative transactions are based on contract(s) and the common law still forms the foundation for derivatives trading.

Fifthly, the variety of market participants complicates the matter. While we frequently see derivative transactions conducted between financial institutions, they are also widely used by business entities of various sizes. In addition, derivative instruments are capable of being employed by ordinary investors/consumers who might have no particular need to hedge but who wish to make profit. An individual might conduct derivatives trading via a broker or a specialised firm, but two individuals might also borrow the transactional structure and make a deal between themselves.

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<sup>9</sup> See *infra* Chapter 4 for further discussion of this issue.

<sup>10</sup> See *infra* Chapter 3.

The five angles mentioned above suggest several ways in which derivative instruments could be approached and examined. Taken together, these different angles give us a multi-dimensional view of derivative instruments. Each derivative instrument could be independently characterised as physical/notional, hedging/gambling, non-standardised/standardised, regulated/unregulated, and business/consumer. To consider the legal implications of derivative instruments, we have to consider the different perspectives of derivatives trading.

## 1.2 Purposes of this Research

In this thesis, we focus on the two major functions of derivatives—hedging and speculation, and we approach them as contracts to trade risks. As will be explained in Chapter 2, derivatives help to commoditise “risk”, a rather abstract concept, into something that can be bought and sold.<sup>11</sup> The use of the more neutral term “risk trading” could provide us with a broader scope to review these contracts, as distinguished from contracts related to exchange for goods or services. Since new derivative instruments are being invented at a very fast pace, viewing them as “risk trading instruments” will help us to avoid the question concerning whether any particular instrument may be defined as a “derivative”.<sup>12</sup> We may also avoid the question concerning whether we have a firm definition of “derivatives” in law.<sup>13</sup> This approach will give us the advantage of having a better overview of hedging, speculation, insurance and gambling. Instead of limiting ourselves to financial institutions, we will have an opportunity to explore risk trading from inter-bank connections to individual customers.

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<sup>11</sup> See *infra* 2.2.2.

<sup>12</sup> For example, see Henderson, *supra* note 6, at 5.10; Feder, “Deconstructing Over-the-counter Derivatives” [2002] Colum Bus L Rev 677, at 713 (regarding credit spread options).

<sup>13</sup> The term “derivative” can be so broadly defined that it is difficult not to include non-derivative transactions. See Henderson, *supra* note 6, at 1.1. Henderson has also compiled several statutory or academic definitions of “derivatives”. See Henderson, Appendix A to Chapter 1. See also Hu, *supra* note 7, at 996 et seq.

From a legal point of view, derivative instruments stand in an area of overlap.<sup>14</sup> In a broader sense, banking, securities, insurance and gambling regulation all have a place in the derivatives market. On the private law side, derivative instruments might be open to the application of insurance contract law, to illegality as a form of gambling contract<sup>15</sup>, or to being recharacterised as a secured loan or guarantee. Nevertheless, general contract law remains the basis of trading. Fiduciary duty, the tort of negligence and fraud or misrepresentation might come into play to shape the relationship between any two given contracting parties. The legal consequences of related regulatory regimes or common law concepts might range from non-interference of law to civil unenforceability and even criminal penalties.

Thus, risk trading as a whole is subject to a significant degree of legal risk,<sup>16</sup> deriving from the fact that risk trading instruments might be characterised or recharacterised as one or several existing legal concepts; thus, certain rules in that area of law would follow. One might also argue that certain special doctrines should be applied or extended to risk trading contracts.

The significance of the legal risks involved leaves us with two questions: “What is the nature of risk trading instruments?” and “How do they fit into existing legal concepts?” On the one hand, we may discuss whether derivative instruments belong to a regulated kind or whether they should enjoy freedom of contract without further regulatory intervention. On the other hand, there are already dedicated rules in each legal field to deal with various problems. Do derivative instruments raise similar concerns that might invite further legal intervention? These are the questions the present thesis attempts to answer. The approach we take may look like civil law, as the common law places less emphasis on special contracts at the expense of general contract law. Nevertheless, it is still a real issue in common law jurisdictions, in light of the existence of insurance law, gambling law, securities regulation and futures

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<sup>14</sup>Derivative instruments have been described as being in the common law no man’s land beyond regulations. Cohen, *supra* note 8, at 2013.

<sup>15</sup> This is based on an assumption that gambling is prohibited or unenforceable in a jurisdiction. See *infra* Chapter 4 for further introduction to gambling laws in the UK.

<sup>16</sup> See also *infra* 2.3.



regulation. Using this approach, we may also form a more coherent line of thinking about laws relating to instruments that involve a certain degree of future uncertainty.

It may be a challenge for a civil law lawyer to write on common law. However, the case law developed in the UK and the US does provide an abundance of materials for any lawyer around the world to consider. This thesis does not argue that there is, or will be, a uniform law regarding derivative instruments that is valid globally, as each country might have its own concerns, and it is beyond the scope of the present thesis to provide legal solutions for every country. However, we do attempt to identify certain general legal issues relating to the trading of risk that might occur in any country, and to provide certain fundamental arguments to resolve these issues based on English law and American law.

## **1.3 Scope of the Thesis**

As derivative instruments could be approached in many different ways, and as it is impossible to host every discussion on every perspective, it is necessary to define the exact scope of the thesis and state what will not be covered in later chapters.

### **1.3.1 Relating to Exchange Trading and OTC Trading**

First, while much of the discussion of this thesis centres on over-the-counter (OTC) transactions,<sup>17</sup> this thesis also takes into account exchange transactions. It is apparent that OTC trading involves far more contract negotiation and thus is exposed to a higher degree of legal uncertainties than is the case with exchange traded products. However, this thesis takes the position that it would be beneficial to have a certain degree of discussion on exchange trading alongside OTC transactions for the following reasons.

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<sup>17</sup> See *infra* 2.2.2.1 for the distinction between exchange-traded and OTC products.

First, the general purpose of the present research is to provide an overview of the trading of risk, illustrated by modern derivative instruments. Exchange-traded contracts, though highly standardised, are still powerful tools for hedging risk and speculating on market prices, and we cannot afford to ignore them. In addition, the exchange market and the OTC market are interrelated. Not only is the pricing of some OTC products derived from a more liquid and transparent exchange market, but a firm might also use both the futures market and the OTC market to hedge risks.

Secondly, there must be a reason why there are far fewer contractual disputes and far less legal discussion with regard to exchange trading. The regulation of futures exchanges only provides part of the answer. The contractual design of exchange provides another angle for explaining certain legal issues and the shortage of contractual disputes in the exchange market. After all, while heavily governed by exchange and clearing house rules, futures trading remains deeply rooted in contract.

Thirdly, given that exchange-traded contracts are largely regulated by financial regulators, the question sometimes arises whether a particular transaction is a regulated “futures” contract as a matter of law.<sup>18</sup> Understanding the exchange market would help us to provide better arguments to protect off-exchange trading schemes from being invaded by futures regulation.

This thesis does not argue that every aspect of exchange trading and OTC trading should be analysed in the same way merely because they might serve similar functions or because in general they are all called “derivatives”. On the contrary, in the present thesis it is proposed to take an overview of potential problems arising in various contexts.

### **1.3.2 Other Issues outside this Thesis**

There are a few related issues that will not be covered in this thesis. First, this thesis will not enter into serious discussion of the documentation issues. This

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<sup>18</sup> See *infra* 3.1.

thesis likewise does not intend to take on the content of the popular master agreement scheme provided by the International Swaps and Derivatives Association (ISDA).

Secondly, this thesis will not analyse derivatives in the context of insolvency law and tax law. Thus, we will refrain from discussing the nature of obligation originating from a derivative transaction in relation to insolvency proceedings or for the purpose of calculating tax.

Thirdly, there is no intention to engage in a full-scale regulatory analysis. Although this thesis will touch upon some issues that might draw regulators' attention, we will not directly answer the question: "How may derivatives be regulated?" Instead, by examining the issue about classification, we may discuss the reasons why certain instruments are already regulated and why there are certain special private law rules in certain legal fields, and we may further examine whether derivative instruments might raise similar problems that might justify further legal intervention. In addition, apart from regulatory solutions, we believe that certain private law aspects should be out in the spotlight before a full regulatory discussion is undertaken. After all, private law solutions should always be taken into consideration before we examine the purposes of regulation and the means to regulate the risk trading market.<sup>19</sup>

Fourthly, this thesis does not provide an in-depth analysis of the restitution issues flowing from local authority cases.<sup>20</sup> Of course, such cases incite much academic debate. However, the main interest of this thesis pertains to the contractual nature and classification of derivative instruments. Thus, we will not enter into details of local authority cases and issues concerning restitution.

Lastly, there are many contractual and regulatory issues relating to modern derivative instruments, and this thesis cannot provide a detailed analysis of every possible issue. Apart from those introduced in Chapters 2 to 5, other contractual

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<sup>19</sup> Nevertheless, whether it is better (in terms of economic efficiency or other factors) to use private law or regulations to address problems arising from derivatives trading is another question that should be further examined. See generally, Partnoy, "The Shifting Contours of Global Derivatives Regulation" (2001) 22 U Pa J Int'l Econ L 421.

<sup>20</sup> See *infra* 2.3.1.

issues of derivative instruments (e.g. breach of contract and damage as well as collateral and credit risk) are not covered, and the reader should excuse the author for being unable to handle them within this limited space.

## 1.4 Map of This Thesis

We begin our analysis by setting the scene. Chapter 2 will illustrate the meaning of risk, certain legal instruments designed to control risk, modern derivative instruments, and certain lawsuits and characterisation problems associated with derivatives trading. We will also explore the problem whether derivative instruments should be seen as capital market instruments or insurance policies.

In Chapter 3, we will focus mainly on the commodity market to examine the turning point between real sales and notional sales, an issue that has serious regulatory implications. To this end, we will analyse the contractual structure of standardised trading and introduce certain judgments to illustrate the boundary between “futures” regulation and commercial sales.

In Chapter 4, we move on to the speculative side of the subject: notional transactions and gambling. The general prohibition on gambling may provide a borderline for acceptable risk trading. We will explore the nature of gambling and notional derivative instruments and provide an analytical structure to host different policy concerns regarding gambling and speculation.

Chapter 5 will focus on the problem of the lack of information inherent in all “risk”, a problem that underlines certain rules in laws related to securities and insurance. As information is crucial for risk assessment, we will examine the applicability of legal doctrines regarding pre-contractual disclosure (e.g. duty of disclosure and insider trading) and whether risk-trading contracts should be categorised as contracts *uberrimae fidei* in insurance law. Chapter 6 presents the conclusion.

## 1.5 Clarification

Before moving on, it is necessary to clarify certain points to avoid confusion. First, given the fast-moving nature of the market and the creativity of financial engineers, it is impossible to discuss all the details of each derivative instrument in this thesis. Thus, this thesis only spotlights certain products in order to generate a better understanding of the issues involved. We will also attempt to point out the possible variations of our main argument necessitated by some less typical products.

Secondly, to avoid monotony, we will use the terms “derivative(s)”, “derivative instruments/transactions”, “risk trading contracts/transactions/instruments” and “hedging/speculative instruments/transactions” interchangeably. As there is in this area much financial jargon, we will attempt to avoid stifling readers with market terminology and will explain important terms where necessary. For simplicity’s sake, we will use the term “derivative” to refer to derivative instruments traded in the OTC market, unless otherwise indicated.

Thirdly, to avoid the confusion between “future” and “futures”, this thesis will use the plural form (“futures”) to refer to exchange-traded forward contracts and futures regulation. The singular form (“future”) will be used to refer to something that may occur in a time to come.

Fourthly, given that the United Kingdom (UK) and the United States of America (US) host the biggest derivatives markets in the world, it is unavoidable that this thesis should start from legal arguments developed in the UK and the US, where case laws provide us with abundant materials to analyse. This thesis is mainly based on UK law, but adds certain US law perspectives for the purpose of comparison. To be more specific, we focus on UK law applying to England. As for US law, we focus on New York and Illinois law (sites of New York City and Chicago, respectively) as samples of US state law, and on US federal law. Limited perspectives on European law will be added where necessary.

# Chapter 2 Risk: Commoditisation and Derivatives

In this chapter, we introduce the background of risk trading, the rise of derivative instruments, and certain legal risks involved in derivatives trading. In the following sections, we will first consider the meaning of risk and various types of risks. Then we will introduce some contract-based legal instruments that help to manage risk and certain legal problems that arise when we attempt to fit derivative transactions into existing legal concepts.

## 2.1 The Meaning of “Risk”

### 2.1.1 Definition

Although widely used in statutes, the term “risk” is not strictly defined in legal language. In the Oxford English Dictionary, risk is defined as a “[h]azard, danger; exposure to mischance or peril” or the “chance or hazard of commercial loss.... Also,... the chance that is accepted in economic enterprise and considered the source of (an entrepreneur’s) profit.”<sup>1</sup> Relevant to the notion of “risk” is the term “uncertainty”, which is defined in the same dictionary as “a business risk which cannot be measured and whose outcome cannot be predicted or insured against.”<sup>2</sup> In a way, risk is “the chancing of negativity—of some loss or harm. ... Risk faces us with the possibility that something untoward may occur, while

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<sup>1</sup> Oxford English Dictionary (2nd edn, 1989), <<http://dictionary.oed.com>> (visited on 10 August 2006).

<sup>2</sup> *Id.*

leaving us unable to foretell any specific outcome with categorical assurance.”<sup>3</sup> Some commentators distinguish “risk” further from “uncertainty” on the ground that the probability of a risk is known (though whether it will actually occur remains unknown), while the probability of an uncertainty remains unknown.<sup>4</sup>

The meaning of “risk” may also be approached from a sociological view. In an article, Giddens describes the rise of a “risk society”, which refers to “a society increasingly preoccupied with the future”.<sup>5</sup> As he explains,

“[t]he idea of risk was first used by Western explorers when they travelled around the world. ... The word refers to a world which we are both exploring and seeking to normalise and control. Essentially, ‘risk’ always has a negative connotation, since it refers to the chance of avoiding an unwanted outcome. But it can quite often be seen in a positive light, in terms of taking bold initiatives in the face of a problematic future”.<sup>6</sup>

Giddens differentiates two types of risk: external risk (which is “risk of events that may strike individuals unexpectedly ... but that happen regularly enough and often enough in a whole population of people to be broadly predictable, and so insurable”) and manufactured risk (which is “risk created by the very progression of human development, especially by the science and technology”).<sup>7</sup> However, he also distinguishes “risk” from hazard or danger, as he argues that a risk society is not necessarily more hazardous or dangerous than in the Middle Ages, a time when dangers were experienced as given.<sup>8</sup> To quote Giddens, “[t]he idea of risk is bound up with the aspiration to control and particularly with the idea of controlling the future.”<sup>9</sup>

If we leave behind the meaning of and distinctions between risk, uncertainty, hazard or danger, in a business sense, “risk” should have monetary effects. For

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<sup>3</sup> Rescher, “Risk: A Philosophical Introduction to the Theory of Risk Evaluation and Management”, at 1 (University Press of America, 1983).

<sup>4</sup> See Eppel, “Risky Business: Responding to OTC Derivative Crises” (2002) 40 Colum J Transnat’l L 677, at 687; Stout, “Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives” (1999) 48 Duke LJ 701, at 743.

<sup>5</sup> Giddens, “Risk and Responsibility” (1999) 62(1) MLR 1, at 3

<sup>6</sup> *Id.*, at 3-4.

<sup>7</sup> *Id.*, at 4.

<sup>8</sup> *Id.*, at 3.

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

example, goods damaged during delivery represent a loss to the owner. Rising crude oil prices will increase the costs of flying and thus reduce airlines' profits. For households, the fluctuation of interest rates might affect their mortgage payments or their returns from a savings account in a bank. It is because of these monetary impacts that risk has to be managed. If the realisation of risk had no impact on their wealth or property values, market participants would not have any interest in controlling it.

In financial terms, there are four basic types of risks.<sup>10</sup> First, there is "market risk", which refers to changes in market prices (e.g. oil prices, stock prices, etc.) or rates (e.g. interest rates).<sup>11</sup> Secondly, there is "credit risk", which arises from the default or insolvency of the counterparty in a transaction.<sup>12</sup> Thirdly, there is "liquidity risk", which refers to the inability to trade instruments due to the absence of counterparties, to finance, or find cash.<sup>13</sup> Fourthly, there is "operational risk", which is generally defined as the risk of loss resulting from inadequate or failed internal processes, people or systems, or from external events, including computer systems processing failures, enforceability of contracts or regulatory factors etc.<sup>14</sup>

Monetary loss may come about through hazards: natural disasters, human misbehaviours, or both. Earthquakes, typhoons, tornadoes, floods, landslides, mudslides, high winds, etc. all are capable of causing loss of human life, damage to property, and economic loss. In addition, monetary losses may also occur through intentional or negligent human behaviour (e.g. car accidents caused by speeding). Sometimes losses are, arguably, caused by both natural forces and human misconduct (e.g. a landslide following torrential rain on an illegally over-developed hill).

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<sup>10</sup> Das, *Risk Management*, at 5 (3rd edn, rev edn, John Wiley & Sons, 2006).

<sup>11</sup> *Id.*

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

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*, at 5 & 1110 (quoting Bank of International Settlement, *International Convergence of Capital Measurement and Capital Standards*, 2004)



The next question is: what does risk mean as a matter of law? The term “risk” is widely used in statutory provisions without a definition.<sup>15</sup> Contractual parties are free to define “risks” by themselves. For example, in an insurance policy, parties might prefer to clearly define what “risk” (or event) is insured so as to determine the insurance coverage. Outside of insurance, the meaning of “risk” can be inferred from sale of goods laws, which make strong references to the transfer of ownership or the possession of goods.<sup>16</sup> However, any inference from the contract or statute needs to be considered on its own particular grounds, and it may be inappropriate to extend such an inference to other contexts.

Risks are eventually translated into rights and obligations.<sup>17</sup> In the sale of goods, the concern is about which party should bear the loss. If a contractual party defaults, the concern is about the rights of the non-defaulting party to seek a remedy. The law itself need not define “risk”, but it has to clarify the rights and obligations between the relevant parties regarding the occurrence of uncertain future events.

Taking into account the different perspectives of “risk” as outlined above, this thesis generally defines it as future uncertainties that may cause monetary losses to a party. From here, we may assess a broader range of transactions intended to cover those future uncertainties, which might arise through market fluctuations (market risk), default of a contractual counterparty (credit risk), an inability to transform an asset into cash or find necessary finance (liquidity risk), system errors or other forms of operational failure during trading (operational risk), changes to the law itself (legal risk<sup>18</sup>), natural disasters, human wrongdoings, and even the longevity of human lives (“mortality risk”<sup>19</sup>), and anything else that might (or might not) happen in the future but will have a monetary effect on a person or a firm. The scope of this thesis is not limited to the “financial risks”

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<sup>15</sup> Using “risk” as a key word to search LexisNexis databases yields more than 700 results from among UK statutes (visited on 10 February 2008). However, no definition of “risk” is found in the UK statutes, nor does the Financial Services Authority (FSA) define it in its handbook.

<sup>16</sup> Sale of Goods Act 1979, section 20(1). See also Bridge, *The Sale of Goods*, at 112 *et seq.* (Clarendon Press, 1997).

<sup>17</sup> Bridge, *id.*, at 112.

<sup>18</sup> See also *infra* 2.3.

<sup>19</sup> See *infra* 2.5.4.

illustrated above, though, of course, these financial risks are the driving forces behind the development of modern derivatives trading.<sup>20</sup> However, loss might also occur through natural disasters or other sources of future uncertainty, and so derivative techniques may also be applied to other non-financial risks.<sup>21</sup> Thus, the present thesis takes a broader view of the meaning of “risk” in order to consider the different sources of future uncertainties.

For clarification, this thesis uses the terms “risk” and “future uncertainty” inter-changeably. There is no distinguishing between “uncertainty” and “risk” on the basis of the probability of occurrence. One may suffer losses through the occurrence of an uncertain event, even though the probability of it happening was formerly unknown. Thus, it does not suit the purpose of this thesis to limit “risks” to those events whose probability can be quantified in percentage points.

### **2.1.2 Risk Management, Hedging and Speculation**

Why do people submit themselves to risk? We may place the background of risk management in the context of the “risk society”, where people start to control the future.<sup>22</sup> In fact, profit and risk are two sides of the same coin. Although risk may lead to a loss, it may also lead to a profit. To some extent, it is similar to gambling: one takes the risk of losing money when one places a bet, but the expected gains might also be high. In a grain sale, if two parties do not want to take on the risks associated with future delivery, their reluctance will greatly limit the amount, price and quality they can bargain for. By undertaking a future delivery contract, they have more choice and might secure a better deal. The advantage is more obvious in an investment. Where an investor buying a stock might profit from the success of a company, he might also suffer losses owing to bad management.

People may have different attitudes toward risks, some being risk-avoiders, others risk-preferers, and still others risk-neutral. The same person might prefer risk in one case, but avoid it in another. This diversity of attitudes contributes to

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<sup>20</sup> See *infra* 2.2.2.

<sup>21</sup> For example, weather derivatives. See *infra* 2.2.2.3.

<sup>22</sup> Giddens, *supra* note 5.

the growth of the “risk” market. On the one hand, a risk-preferer might attempt to earn a profit from or make better use of his assets in light of future uncertainties: a typical kind of risk-preferrer is what is generally called a “speculator”.<sup>23</sup> On the other hand, a risk-avoider might attempt to control or minimise the potential negative effects of future uncertainties, which leads to the management of risks. “Hedging” is the word commonly used to refer to how market participants control their risk exposure.<sup>24</sup> In this thesis, we will use the term “hedging” loosely to cover the behaviour to control risk exposure. Like the supply and demand for goods, the voluntary exchange of risk involves a buyer and a seller of risk. Thus, hedging and speculation necessarily co-exist in the market.<sup>25</sup> In order for risk-avoiding parties to sell their unwanted risks, there must be risk-takers willing to buy them.

Generally, there are two levels of risk management: “trading risk management” and “firm wide risk management”.<sup>26</sup> The former refers to risk management at the level of individual traders and trading desks in relation to specific transactions (e.g. a lender’s hedge for a loan of GBP £100 million). The latter refers to the aggregate risk management at the level of the trading desk, business unit or firm itself where the aim is to match risk with capital (e.g. hedging for the overall risk exposure of a bank).<sup>27</sup> Which risk management strategy is chosen depends not only on the attitude of the market participant but also on the type of trader he is. It is one thing when the need to hedge comes from a single transaction (e.g. a bank’s entering into a loan agreement with a borrower). It is a different story if a trader faces continuous exposure to market prices (e.g. an airline company’s exposure to fuel prices).<sup>28</sup>

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<sup>23</sup> We will further examine the meaning of speculation and its difference from gambling in Chapter 4. See *infra* 4.4.1.

<sup>24</sup> Hudson, *Law on Financial Derivatives*, at 2-14 (4th edn, Sweet & Maxwell, 2006).

<sup>25</sup> See Clark, “Genealogy and Genetics of ‘Contract of Sale of a Commodity for Future Delivery’ in the Commodity Exchange Act” (1978) 27 *Emory LJ* 1175, at 1205 *et seq.*

<sup>26</sup> Das, *supra* note 10, at 4.

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

<sup>28</sup> *Id.*, at 10-12.

## 2.2 Contractual Instruments for Managing Risk

Given the monetary effects of risk on human beings, it is not surprising that people have developed contractual instruments to control risk exposure. Before introducing these contractual instruments, there is a need to recognise the role of some other non-contractual legal regimes in controlling risk. First, property law and tort law serve some risk allocation functions. The law of property deals with the ownership and control of a property, allocating risks in terms of property rights and obligations. The law of tort tracks the consequences of a human wrongdoing, by imposing liabilities on the wrongdoer to compensate the victim. In economic theory, “[t]he economic purpose of tort liability is to induce injurers to internalize these costs. ... When potential wrongdoers internalize the costs of the harm that they cause, they have incentives to invest in safety at the efficient level”<sup>29</sup>, and thus, the potential risk can be reduced. Secondly, some laws and regulations set up certain standards of conduct. For example, labour laws require employers to establish safety measures to protect the health of their employees.<sup>30</sup> Product safety regulations require manufacturers to follow certain rules in order to ensure the safety of their product.<sup>31</sup> Financial regulations impose prudential requirements and conduct of business standards to protect investors.<sup>32</sup> It is not our intention in this thesis to cover every safety measure or deterrence regime. Rather, we will focus on how parties can control their risk exposure using contracts.

### 2.2.1 Traditional Instruments

It is natural for contractual parties to manage risks in a contract. First, to some extent, the contract itself has an insurance function.<sup>33</sup> Parties can also use

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<sup>29</sup> Cooter & Ulen, *Law and Economics*, at 290 (3rd edn, Addison-Wesley Longman, 2000).

<sup>30</sup> For example, the Health and Safety at Work etc Act 1974.

<sup>31</sup> See Consumer Protection Act 1987, s 11. For example, Toys (Safety) Regulations 1995, SI 1995/204.

<sup>32</sup> See FSA Handbook, Prudential Standards and Business Standards.

<sup>33</sup> Posner, *Economic Analysis of Law*, at 104 *et seq.* (6th edn, Aspen, 2003).

contractual terms to cope with the potential realisation of risk during the performance of a contract (e.g. the default of the counterparty, a hazard occurring during delivery, etc.), subject to their bargaining power and negotiation skills. Standard contracts may provide an acceptable risk allocation mechanism, and so partly solve some problems if parties use the same standard form.<sup>34</sup>

Whenever parties cannot allocate risk in the contract, the law of contract can fill the gap. For example, the doctrine of frustration addresses those future uncertain events that render a contract impossible to perform.<sup>35</sup> Transfer of ownership or delivery of possession of goods sometimes determines who bears the risk of loss.<sup>36</sup>

However, even the law of contract cannot provide perfect hedging. For example, some doctrines, such as that of frustration, are interpreted so strictly that they are difficult to apply.<sup>37</sup> Under English law, price movement alone cannot normally trigger the application of the doctrine of frustration.<sup>38</sup> Although Lord Reid seems to reserve his opinions on the position “if the increase had reached an astronomical figure”<sup>39</sup>, as no such claim having been made, we find it difficult to create much room to apply the doctrine of frustration to a commodity sale only because of a dramatic movement of commodity prices. As the main purpose of a fixed-price contract of sale is to buy and sell at the contract price, the buyer’s pain is the seller’s gain, and *vice versa*. Thus, the conflict of interest of the two parties implies that the purpose of a fixed-price transaction cannot easily be frustrated as it serves at least one party’s benefit. US law also takes the same position on this subject.<sup>40</sup>

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<sup>34</sup> For example, the FOSFA Contract for Vegetable and Marine Oil (in bulk) FOB terms (FOSFA No. 53) provides a Force Majeure clause to cope with various natural or human hazards, a Bankruptcy/Insolvency clause in the case where one party goes bankrupt, and a Default clause to determine the effect of default by one party. See FOSFA Contract No. 53, clauses 22, 24 & 26.

<sup>35</sup> See *Taylor v Caldwell* (1863) 3 B&S 826.

<sup>36</sup> Sale of Goods Act 1979, section 20(1).

<sup>37</sup> In *J Lauritzen AS v Wijsmuller BV (the “Super Servant Two”)*, Bingham LJ opined that “[s]ince the effect of frustration is to kill the contract and discharge the parties from further liability under it, the doctrine is not to be lightly invoked, must be kept within narrow limits and ought not to be extended.” [1990] 1 Lloyd’s Rep 1, at 8.

<sup>38</sup> Cf. *Davis Contractors Ltd v Fareham UDC* [1956] AC 696.

<sup>39</sup> *Tsakiroglou & Co Ltd v Noblee Thorl GmbH* [1962] AC 93, at 118.

<sup>40</sup> See Restatement of Contracts 2d, section 261, Comment d.

Nevertheless, even if parties may not hedge all the risks of a transaction in a single contract, and even if the law of contract cannot fill the gap perfectly, contracts still play a pivotal role in managing risk. Contracts also represent how parties intend to allocate between them the risks from a transaction. Not only do many of the legal instruments that will be mentioned take the form of a contract, but also they are often specified in the core contract of a transaction. For example, a loan agreement normally requires the borrower to provide security interests or a guarantee, and long-distance trade frequently requires insurance. Whenever it is not clear how contract law or other private law regimes would allocate risk exposure between contractual parties, the contract itself is the only point of reference that we might draw to establish the intention of the parties concerned. Thus, the basic contractual instrument should be the starting point.

Secondly, it is common for one party of a transaction to require the other party to provide extra protection. The purpose of providing extra protection is to give the first party additional resources either to secure payment or to seek damages. A broader concept of such protection is indicated by the term “collateral”. Extra protection can be obtained by providing either additional promises of a third party or properties for value. The former is exemplified by guarantees and the latter by security interests. .

Parties can support their contractual position by securing a promise from another credible person. A guarantee is a promise of a third party to repay the money if the principal debtor is in default, or to compensate for loss if the principal debtor does not perform according to the contract (e.g. the guarantor of an employment contract).<sup>41</sup>

Property-based protection is far more complicated. In England, security interests can be attached to realty and personalty, and to tangible or intangible properties. Some require a transfer of title (e.g. mortgage), some only the delivery of possession (e.g. pledge), and some neither (e.g. charge). They can be attached to existing or future assets. There is also an important distinction between a fixed security and a floating security. The former is attached to specific

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<sup>41</sup> See *Moschi v Lep Air Services Ltd* [1973] AC 331 (*per* Lord Diplock).

property and the latter to a shifting fund of assets where the debtor's management power (the exercise of which is a source of risk for the creditor) is brought to an end when the charge crystallises.<sup>42</sup> In addition, it is also possible to arrange for the goods supplied under a contract of sale to amount to security against future payments. In a conditional sale, the seller retains the title of the goods until the price is paid, while the buyer enjoys the possession and use of the goods in advance and acquires the title after full payment.

It is not the purpose of this thesis to outline the absolute limit of what security interests, guarantees or other types of collateral (or credit enhancement) could or could not do other than securing against credit risk. Security interests and guarantees are useful tools to control credit risk, but they are not able to solve all problems arising from market fluctuations. However, the line between instruments for controlling credit and market risks may be blurred in light of modern developments with financial transactions. As will be discussed below, the "margin" in the exchange trading market operates as a way to limit a trader's loss (and thus the credit risk) if he cannot meet a margin call after the daily settlement of his exchange contracts (see 3.2.3.1 below). The same mark-to-market strategy (see 3.2.3.1 below) could be used in many off-exchange transactions (and collateral agreements).<sup>43</sup> In this way, collateral might be linked to market fluctuations. To a certain extent, it is up to the creativity of practitioners and market participants. We argue simply that these instruments are created mainly for credit risk purposes. Market participants are of course free to develop further uses for these instruments.

Thirdly, insurance<sup>44</sup> is a traditional method for managing risk. If we temporarily leave the definition of insurance for the time being (see 2.5.1 below),

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<sup>42</sup> Goode, *Legal Problems of Credit and Security*, at 1-10 (3rd ed., Sweet & Maxwell, 2003).

<sup>43</sup> See generally, Hudson, *Law on Financial Derivatives*, chapter 12 (4th edn, Sweet & Maxwell, 2006); Henderson, *Henderson on Derivatives*, chapter 21 (LexisNexis Butterworths, 2003).

<sup>44</sup> A dictionary definition of insurance is "[t]he act or system of insuring property, life, etc.; a contract by which the one party (usually a company or corporation) undertakes, in consideration of a payment (called a premium) proportioned to the nature of the risk contemplated, to secure the other against pecuniary loss, by payment of a sum of money in the event of destruction of or damage to property (as by disaster at sea, fire, or other accident), or of the death or disablement of a person; the department of business which deals with such contracts" *Oxford English Dictionary* (2nd edn, 1989), <<http://dictionary.oed.com/>> (visited on 10 August 2006).

in essence, an insurance contract shifts a specific risk from the insured to the insurer. The insured has to pay a certain amount of money in return for the insurer's indemnification of his loss or payment on the occurrence of a certain event irrespective of the loss.<sup>45</sup>

It is necessary at this stage to take note of the types of insurance policies on the market under current regulations. Under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO 2001),<sup>46</sup> a "contract for insurance" means "any contract of insurance which is a contract of long-term insurance or a contract of general insurance ..."<sup>47</sup>. Under the RAO 2001, "contracts of long-term insurance" include: contracts of insurance and contracts to pay annuities on human life (life and annuity);<sup>48</sup> contracts of insurance (for more than 1 year) to provide a sum on marriage or on the birth of a child (marriage and birth);<sup>49</sup> contracts of insurance (or to pay annuities) on human life where the benefit is determined by reference to the value (or income) of a property (linked long-term);<sup>50</sup> contracts of insurance providing specified benefits against risks of a person becoming incapacitated in consequence of sustaining injuries as a result of an accident (permanent health);<sup>51</sup> tontine;<sup>52</sup> capital redemption contracts by non-banking insurance businesses;<sup>53</sup> pension fund management;<sup>54</sup> collective insurance;<sup>55</sup> and social insurance.<sup>56</sup>

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<sup>45</sup> "[I]t appears that there are two categories of insurance which may respectively be called indemnity insurance and contingency insurance. Indemnity insurance provides an indemnity against loss... Within the limits of the policy the measure of the loss is the measure of the payment. Contingency insurance provides no indemnity but instead a payment upon a contingent, as in a life policy or a personal injury policy." *Medical Defence Union v Department of Trade* [1982] Ch 82, at 89 (*per* Sir Robert Megarry VC).

<sup>46</sup> SI 2001/554.

<sup>47</sup> RAO 2001, paragraph 3(1). This distinction generally corresponds to the distinctions between life insurance and non-life insurance under European legislation. *See* Paul, "Insurance Regulation" in Blair (ed.), *Financial Services Law*, at 14.01 & 14.23-25 (OUP 2006).

<sup>48</sup> *Id.*, Schedule 1, Part 2, paragraph I.

<sup>49</sup> *Id.*, paragraph II.

<sup>50</sup> *Id.*, paragraph III.

<sup>51</sup> *Id.*, paragraph IV.

<sup>52</sup> *Id.*, paragraph V.

<sup>53</sup> *Id.*, paragraph VI.

<sup>54</sup> *Id.*, paragraph VII.

<sup>55</sup> *Id.*, paragraph VIII.

<sup>56</sup> *Id.*, paragraph IX.



On the other hand, contracts of general insurance include: insurance policies for accidents (for a person's sustaining an injury or suffering death following an accident);<sup>57</sup> contracts of insurance against risks of loss attributable to sickness or infirmity;<sup>58</sup> insurance against the risk of loss or damage to a vehicle on land, railway rolling stock, aircraft, ships, goods in transit, fire and natural forces, and insurance against damage to property (including theft);<sup>59</sup> insurance against damage in connection with the use of motor vehicles on land, aircraft and ships;<sup>60</sup> insurance against the risk of incurring liability against a third party;<sup>61</sup> insurance against the risk of loss from the insolvency of debtors or from failure of payment;<sup>62</sup> suretyship;<sup>63</sup> insurance against miscellaneous financial loss;<sup>64</sup> insurance against incurring legal expenses;<sup>65</sup> and contracts of insurance to provide assistance should the assured get into difficulties while traveling or in other circumstances.<sup>66</sup> Frequently, an insurance company can package different types of insurance into one policy.<sup>67</sup>

As the introduction above shows, insurance companies provide protection against accidents, sickness, natural hazards, credit default of a person, human wrongs and the life or death of a human being. A more thorough analysis of insurance and insurance laws will be given later in this chapter (see 2.5 below).

Lastly, shifting risk exposure from one person to another is one way to reduce risk exposure. However, a risk buyer is still exposed to the same risk if a potential loss is simply shifted from one party to another. The risk buyer in one transaction might have to shift the risk to another party or in some cases to many

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<sup>57</sup> RAO 2001, Schedule 1, Part 1, paragraph 1.

<sup>58</sup> *Id.*, paragraph 2.

<sup>59</sup> *Id.*, paragraphs 3–9.

<sup>60</sup> *Id.*, paragraphs 10–12.

<sup>61</sup> *Id.*, paragraph 13.

<sup>62</sup> *Id.*, paragraph 14.

<sup>63</sup> *Id.*, paragraph 15.

<sup>64</sup> *Id.*, paragraph 16. See also *infra* 2.5.1.

<sup>65</sup> *Id.*, paragraph 17.

<sup>66</sup> *Id.*, paragraph 18.

<sup>67</sup> For example, the Homeowner's Insurance provided by Providential can cover damage to the main property, personal belongings, loss of use, personal liability and third parties' medical expenses, depending on the policy. See <http://www.prudential.com/productsAndServices/0,1474,intPageID%253D3908%2526blnPrinterFriendly%253D0,00.html> (visited on 10 August 2006).

other parties. The impact of risk is minimised if it is shared by other people rather than staying with one person.

Before the modern creation of derivatives, the traditional way of hedging was to seek help from other people who were in a similar position. Thus, there emerged mutual associations or clubs whose members would share the burden if one of their fellows suffered losses. Since money is required to cover losses, members might have to make a promise to share any loss suffered by another member or to contribute a certain amount of money to form a pool of funds in order to cope with the realisation of risks.

To some extent, the idea of mutuality is similar to insurance. Mutual protection has existed for hundreds of years in many parts of the world. It first started in agricultural societies, where people in a relatively close community would share property or human losses. For example, if ten villagers decided to share the losses of cattle from theft, they might form a mutual association where each villager periodically contributes a certain amount of money into a pool. Then whenever a villager's cattle are stolen, the pooled money is used to compensate him for his loss: in this way, the risk of theft is shared among ten villagers rather than remaining with the one person. In the UK, this could be what is generally called a "friendly society". The same idea has survived the emergence of insurance policies. Protection and indemnity clubs for marine insurance in the UK are a good example.<sup>68</sup> The structure of mutual risk sharing could range from contractual agreement(s) to the establishment of trusts, pools of funds, and mutual associations controlled by membership. In the modern era, a mutual association could also be incorporated as a company.<sup>69</sup>

To some extent, the same thing happens in an indirect way to retail insurance policies. An insurer might try several ways to minimise its risk exposure. Apart from using reinsurance, an insurer actually spreads his risk to a majority of

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<sup>68</sup> For the historical development of P&I clubs and their predecessors, see chapter 1 of Hazelwood, P&I Clubs: Law and Practice (3rd edn, LLP, 2000).

<sup>69</sup> If a mutual association is incorporated as a company, members contract with the company rather than with other members. Therefore, a member could enforce his right against the company but not against other members.

assureds facing the same situation by carefully calculating premiums to reflect not only the personal traits of each assured but also the general tendency to exposure to the same type of risk, following the law of large numbers. In this way, risk exposure is to some extent shared by all assureds. Social insurance is more inclined in this direction.

The discussion above focuses on instruments that help market participants to control risk exposure. In contrast, there are also instruments that help market participants to make speculative profits by gaining risk exposure. Gambling contracts are typical examples of contracts to take a risk.<sup>70</sup> A punter to a gambling contract intentionally exposes himself to future uncertainties by placing a bet. In a way, investment activities may also be seen as contracts to make a profit from future uncertainties. Whatever investment vehicle (stock, bonds, commodities, real estate, collectible goods, etc.) that an investor purchases or sells, he attempts to make a profit out of future market movements of the underlying instruments.

Of course, every transaction or human activity may invite a certain degree of risk exposure. Thus, it is meaningless to argue that all contracts are risk trading contracts. In contrast, the purpose of the above discussion is to show that there are legal instruments that help market participants to control or avoid risk exposure as well as make profits by exposure to future uncertainties.

## **2.2.2 Derivatives**

### **2.2.2.1 General Definition**

In general, a derivative “can be defined as a financial instrument whose values depend on (or derive from) the values of other, more basic underlying variables.”<sup>71</sup> In a way, derivatives “allow trading in the return or price fluctuations of other assets *without the necessity of trading in the assets themselves*”.<sup>72</sup> Although derivatives have been developing since the 1970s and

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<sup>70</sup> See *infra* 4.2.1 for types of gambling.

<sup>71</sup> Hull, *Options, Futures, and Other Derivatives*, at 1 (6th edn, Prentice Hall, 2006).

<sup>72</sup> Das, *Derivative Products & Pricing*, at 4 (3rd ed., rev. edn, John Wiley & Sons, 2006).

in particular since the 1980s, some derivatives, such as forward contracts and options, have existed for centuries.<sup>73</sup> Even if the derivative itself is highly risky,<sup>74</sup> it is still a powerful weapon for combating risk. In a way, “applications of derivative instruments focus on using derivatives to transfer risk”.<sup>75</sup>

The umbrella term of “derivative” may refer to a wide range of financial products traded in different forms and based on a variety of underlying assets. The four general categories of derivatives include options, futures, forward contracts, and swap agreements. There are so-called hybrid (or structured) instruments that incorporate certain derivative techniques into a traditional instrument (such as bonds). If we focus on the types of underlying asset, we might also divide derivatives into categories such as credit derivatives (e.g. derivatives on corporate bonds), currency derivatives (e.g. relating to foreign exchange), equity derivatives (e.g. relating to stock), and commodity derivatives (e.g. relating to crude oil). Looking at the place where derivative instruments are traded, those traded on organised exchanges may be differentiated from those traded in the over-the-counter (OTC) market.

The most basic elements of derivatives trading are option and forward contracts.<sup>76</sup> Options require the holder to pay an amount of money (the premium) in return for a right (but not an obligation) to buy (a “call” option) or sell (a “put” option) certain underlying assets or products at a certain fixed price (the strike price). The basic structure may be varied to make a so-called “exotic option”.<sup>77</sup> For example, market participants might reset the strike price according to a certain pre-determined formula (e.g. a “lookback option”<sup>78</sup>),

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<sup>73</sup> For a historical background, *see* Gengatharen, *Derivatives Law and Regulation*, at 8-12 (Kluwer Law International, 2001). For development of the swap agreement, *see* Henderson, *supra* note 43, at 1.13; Hudson, *supra* note 24, at 2-01 (4th edn, Sweet & Maxwell, 2006); Romano, “A Thumbnail Sketch of Derivative Securities and Their Regulation” (1996) 55 Md L Rev 1, at 7 & 40-41.

<sup>74</sup> *See infra* 2.2.2.5 for further discussion of the risks of derivative trading.

<sup>75</sup> Das, *Structured Products Volume 1: Exotic Options; Interest Rates & Currency*, at 117 (3rd ed., rev edn, John Wiley & Sons, 2006).

<sup>76</sup> Das, *supra* note 72, at 8; Hudson, *supra* note 24, at 2-05.

<sup>77</sup> *See generally*, Das, *supra* note 75, Chapters 5 *et seq.*

<sup>78</sup> A “lookback option” is an option where the optionholder has the right to set the strike price at the expiration of the option at the most favourable price for the underlying asset that has obtained during a specified time. Das, *id.*, at 212 & 288.

“knock in” or “knock out” the validity of an option (e.g. a “barrier option”<sup>79</sup>), or revise the option’s pay-off structure (e.g. a “digital option”<sup>80</sup>). In addition, by combining several options together, one may create a different pay-off structure. For example, a “bull spread” involves “buying a call option on a stock with a certain strike price and selling a call option on the same stock with a higher strike price”.<sup>81</sup> This strategy limits both the investor’s upside and downside risks.<sup>82</sup>

In a forward contract, the buyer agrees to buy and the seller agrees to sell a specified underlying asset on a specified date at a specified price (the “forward price”).<sup>83</sup> Depending on the underlying asset, a forward contract might require the delivery of the underlying asset (e.g. equity or commodities) or a cash settlement (e.g. for interest rates or index forwards). However, a forward contract for a physically deliverable underlying asset may be settled in cash if so desired. Both forward contracts and options can be traded on an exchange. Exchange-traded forward contracts are generally called “futures” by market participants.<sup>84</sup>

In addition, a swap is in essence an exchange of cash flows:<sup>85</sup> thus, in a way a swap could be seen as a composition of forward contracts.<sup>86</sup> The calculation of cash flows might be based on interest rates (an “interest rate swap”<sup>87</sup>), currency rates (a “currency swap”<sup>88</sup>) or any other rates, indices or measures (e.g. the “forward freight rate swap”<sup>89</sup>). There is an abundance of swap transactions, some of which will be introduced later in this chapter (see 2.2.2.3 below).

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<sup>79</sup> A barrier option would activate (knock in) or expire (knock out) if the price of the underlying asset breaches a specified level (the “barrier”). A barrier option might provide the holder with a structured hedge with a lower premium. See Das, *id.*, at 333 *et seq.*

<sup>80</sup> A digital option is an option with a fixed payout, regardless to what extent the option is “in-the-money”. See Das, *id.*, at 385 *et seq.*

<sup>81</sup> Hull, *supra* note 71, at 225–226.

<sup>82</sup> *Id.*, at 226.

<sup>83</sup> Das, *supra* note 72, at 9.

<sup>84</sup> In contrast, the meaning of “futures” in law might contain both exchange-traded futures and off-exchange forward contracts. See *infra* 3.1.

<sup>85</sup> Hudson, *supra* note 24, at 2-73.

<sup>86</sup> “Swap contracts are essentially a package or portfolio of forward contracts that are combined into a single transaction.” Das, *supra* note 72, at 83.

<sup>87</sup> See *infra* 2.2.2.3.

<sup>88</sup> See *infra* 2.2.2.3.

<sup>89</sup> See *infra* 2.2.2.3.

Having the above introduction in mind, this thesis takes the position that, from a legal point of view, it is better to analyse each derivative instrument according to the market where it is traded. To quote Henderson's classification:

"Broadly speaking, the term 'derivatives' includes three main groups of financial products:

- Individually negotiated, bilateral, [over-the-counter (OTC)] transactions such as swaps and forwards, with payments or deliveries based and valued on movements in interest, currency, equity or commodity rates, prices, or indices or other priceable variables applied to a notional amount or quantity, and swap-related products which are, or have certain characteristics similar to, options (including caps, floors and OTC options on those rates, prices, indices or variables or on the securities, commodities or other underlying physical assets themselves);
- debt obligations (hybrid securities or securitised derivatives) with 'unusual' rate of return, which can be viewed as standard debt securities with OTC derivatives of the preceding type embedded into them; and
- exchange-traded futures and options which, since they are traded on regulated exchanges in a standardised form, do not present most of the credit and structural issues arising from OTC derivatives ..."<sup>90</sup>

Exchange trading is much standardised, with the result that contractual problems tend to be resolved on the basis of the rules of an exchange/clearing house (see Chapter 3 below). The OTC market, in contrast, allows much more contract negotiation, so there is more room for private law to intervene. Hybrid instruments create another class of problems, as they might be seen as securities or other existing capital market instruments. This thesis assumes that analysing derivative instruments under this classification is beneficial as it reflects the different contractual structures having legal implications for contract lawyers and regulators. In the following sections, we will introduce some derivative instruments and their applications according to three categories: exchange-traded products, OTC products, and hybrid instruments.

#### **2.2.2.2 Exchange-traded Products**

Modern futures trading first developed in the grain market. Initially, grains were traded on the spot. Since this could only take place during periods of grain

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<sup>90</sup> Henderson, *supra* note 43, at 1.1 (LexisNexis Butterworths, 2003).

production, it was risky for both the farmers and buyers alike because grain prices depended on many external factors. A later development was to contract in advance for future deliveries, which, most importantly, allowed the price to be fixed even before the grain was produced.

In 1848, the Chicago Board of Trade (CBOT), the first modern organised futures market in the world, was established.<sup>91</sup> Traders soon realised that the futures market provided an effective playground for hedging and speculation, because traders did not need to make a delivery unless they held an open position (i.e. contracts not being liquidated<sup>92</sup>) at the end of trading. Therefore, trading volume in a contract month might be more than the actual quantity available for delivery. Since the 1970s the market has grown with futures trading spreading from grain sales to the notional trading of commodities, to securities trading and to purely financial futures (such as index futures).<sup>93</sup> Financial engineers have masterminded many complex hedging strategies that involve the use of forward contracts, futures and options in combination with spot market transactions in order to balance expected losses with risks and potential profits.<sup>94</sup>

How can the futures market be used to hedge risks?<sup>95</sup> For example, if a buyer fears that the cost of Brent oil will be higher than £50 per barrel in July (i.e. the time delivery is required), he can enter into the London Brent futures market to buy Brent Crude Oil futures (July delivery) for £50 per barrel to cover his future transactions in July. Assuming that the spot market Brent price is £55 per barrel in July (and also assuming that the futures prices and spot prices converge at the

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<sup>91</sup> See <<http://www.cbot.com/cbot/pub/page/0,3181,942,00.html>> (visited on 10 August 2006). It has also been reported that Japan's ancient rice futures market, which first appeared in the 17th century, was the first ever organised futures exchange in history. Turner & Suzuki, "Japan Plans to Resurrect Rice Futures Market" Financial Times (9 December 2005).

<sup>92</sup> The process of liquidation is introduced in *infra* 3.2.3.2.

<sup>93</sup> The Chicago Mercantile Exchange claimed that it launched the first financial future in the world, the Japanese Yen futures, in 1972. See <<http://www.cme.com/about/ins/caag/history2801.html>> (visited on 10 August 2006). Chicago Board of Trade launched the first financial futures, the GNMA futures, in 1975. See <<http://www.cbot.com/cbot/pub/page/0,3181,942,00.html>> (visited on 10 August 2006).

<sup>94</sup> For example, the NYMEX's website also introduces several trading strategies involving futures and options. See <[http://www.nymex.com/option\\_strat.aspx](http://www.nymex.com/option_strat.aspx)> (visited on 3 December 2006).

<sup>95</sup> We should be aware that the same hedging strategy could be employed with an off-exchange forward contract. Thus, we would not repeat when we discuss OTC products later.

end), the buyer pays £55 per barrel for the spot market contract but can recover £5 if he settles the futures contract in cash at £55 per barrel. However, if the spot market price is £45 per barrel in July, then the cheaper spot prices are offset by the loss of £5 (£45 - £50) in the futures contract. Thus, putting to one side the costs of trading, the oil price is fixed at £50.<sup>96</sup> A seller can use a similar strategy except that he is selling a futures contract instead of buying.<sup>97</sup> We should be aware that the result of fixing a future price is not always desirable. In the above example, the hedge pays off when the July price exceeds £50 per barrel; however, the hedge literally becomes a loss if the price stays below £50. This is a risk that the buyer has to take when entering into a hedging transaction. It also reflects the fact that a hedge may work against the hedger if the market moves in an unexpected direction.

By using the hedging strategy described above, a trader effectively turns the combination of spot market transactions and futures transactions into what financial engineers call “basis” trading. A “basis” is defined as the difference between the spot market price (e.g. May corn price) and the most imminent futures prices (May corn futures price in the CBOT).<sup>98</sup> Suppose a farmer wants to take advantage of the relatively higher May corn futures to hedge against potential price movements. The farmer sells a certain amount of May corn futures in the CBOT at price F1. In May 2008, the farmer sells his corn in the spot market to another trader at price S2, and also settles his corn futures at price F2. Thus, the overall sale price for the farmer is the spot price (S2) plus any gain or loss from his futures transactions (F1-F2). The farmer’s real earnings are the futures prices in the first period (F1) plus a “basis” in period 2 (S2-F2).<sup>99</sup> In this way, a farmer can use current futures prices as a starting point to hedge his spot transactions in the future. The farmer (as the seller) must pick the best time to

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<sup>96</sup> This strategy is commonly called a “long hedge”.

<sup>97</sup> This is commonly called a “short hedge”. See also *Gebrüder Metelmann GmbH & Co KG v NBR (London) Ltd* [1984] 1 Lloyd’s Rep 614, at 623–624 (per Mustill J).

<sup>98</sup> If the future price is higher, the basis can be lower than zero. See Das, *supra* note 75, at 47–51.

<sup>99</sup> In short, the formula works in this way: (Real costs) =  $S2 + (F1 - F2) = F1 + (S2 - F2) = F1 + \text{Basis}$ . F1 refers to the futures price in period one, when the farmer starts to contend for hedging. F2 is the futures price in period 2, when the spot transaction is made. S2 is the sale price in the spot market.



enter into spot market trading (i.e. when the basis is highest) to maximise his sale price.<sup>100</sup> The same is applicable to a buyer and a long hedge, except that the buyer would want the basis to be as small as possible. Once commodity traders merge the above strategy into a single transaction, it becomes what people call a “hedge-to-arrive” contract or basis contract (discussed in 3.3.1 below).

For some final comments, the futures market is highly standardised, so price is virtually the only term subject to negotiation during the trading sessions. As will be explained in Chapter 3, the exchange market has almost become a “contract market”,<sup>101</sup> where market participants no longer trade the underlying asset of a futures contract but the “futures contract” itself.<sup>102</sup>

### 2.2.2.3 OTC Products

A variety of standard or exotic options, forward contracts, swaps and structured products are traded in the over-the-counter (OTC) market, linking to equity, bond, commodity, and/or currency prices. As the market continues to grow, it is becoming virtually impossible to make a complete list of the products available to market participants. As we have briefly introduced the meaning of forward contracts and options above (section 2.2.2.1) and the techniques for using forward contracts to hedge and speculate are very much the same as those for using exchange-traded contracts, we will focus on certain types of swap agreements in this section.

In a typical interest rate swap, one party pays at a fixed interest rate (the fixed rate payer) and the other pays at a floating rate (the floating rate payer), based on a notional principal amount<sup>103</sup>. The fixed-rate payer enjoys more controllable cash flows because his interest payment is fixed, but he may suffer if the market

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<sup>100</sup> This simple example does not consider the costs of the futures trading (e.g. brokers' commission) and the potential need to roll over futures positions if a trader does not make a spot transaction when his futures positions mature.

<sup>101</sup> The term is used in the US Commodity Exchange Act to refer to futures exchanges. See 7 USCA 1a.

<sup>102</sup> This is a point that will be elaborated further in *infra* Chapter 3.

<sup>103</sup> The principal amount in an interest rate swap is notional because there is no real exchange of cash flow regarding the principal. The principal amount is deemed to exist only for calculation purposes.

rate later declines. On the other hand, the floating-rate payer may gain from a lower market but suffer if the market rises.

Frequently, parties enter into interest rate swaps because of their financial or commercial needs. For example, a company issues a bond with floating-rate interest payment obligations. By entering into a swap, this company might change its floating rate obligation into a fixed rate obligation thereby making its cash flow more predictable. In contrast, a bondholder with a fixed rate cash inflow each period might turn his fixed payment into a floating payment if he expects a rising market rate. Since it is not always easy to find another party with the same needs in the market, financial intermediaries (such as banks) play an important role in matching transactions or actually stepping into the market to buy or sell swaps. In such cases, financial institutions often enter into back-to-back swaps on the same terms with another institution.<sup>104</sup>

Currency swaps are more complicated. In a traditional currency swap, the first step is for the two parties to exchange amounts in different currencies on the basis of an agreed exchange rate (e.g. 2 million US dollars and 1 million pounds sterling). Then, there will be periodic payments (usually calculated according to an agreed interest rate for the underlying currency) between the parties in the currency that each one receives (e.g. the party receiving 1 million pounds at the first stage makes periodic payments in pounds sterling to the other party). At the end, there is another exchange of currency, which is the reverse of the first stage.<sup>105</sup> In this way, a UK company with an income in US dollars might exchange with a US company having an income in pounds sterling without being exposed to fluctuations in the exchange rate between the US dollars and British pounds until the end of the currency swap.

The use of a fixed-for-floating strategy is not limited to interest or currency rates. For example, in an equity swap, one party makes a fixed or floating interest

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<sup>104</sup> For example, taken facts from *Caisse Nationale de Credit Agricole v CBI Industries, Inc*, 90 F 3d 1264 (1996), while contracting with CBI, Caisse Nationale de Credit entered into a back-to-back agreement under the same terms and conditions with the Bankers Trust. See also *Morgan Grenfell & Co Ltd v Welwyn Hatfield District Council* [1995] 1 All ER 1; *infra* 4.1.1.

<sup>105</sup> See Hudson, *supra* note 24, at 2-100.

payment on the basis of a notional amount plus any depreciation of an equity price or index, in exchange for the return on the equity price or index (including any appreciation of prices and distribution of dividends), calculated notionally in monetary terms.<sup>106</sup> Nor are swaps limited to market prices or indices. For example, in weather derivatives, a party planning to hedge against an unexpectedly warm or cool season (e.g. an air-conditioner manufacturer) may pay a fixed sum of money for an option to buy a weather index, calculated according to the total number of heating degree days (HDD), in order to measure a year's relative "coolness".<sup>107</sup> In short, it is like an index option or swap, except that the index refers to the weather. In theory, any floating price, such as maritime freight rates,<sup>108</sup> is susceptible of being swapped.

Credit derivatives provide another facet.<sup>109</sup> In a credit default swap (CDS), a party wishing to hedge the credit risk of a "reference obligation" (e.g. a bond) makes a fixed payment periodically or in a lump sum and receives payment from the other party if the "reference entity" (e.g. the bond issuer) defaults, thereby allowing bondholders to hedge the credit risks of the bond issuer. The credit default swap has evolved to cover not only the default of a single debt instrument but also the default of one or several debt instruments in a portfolio.<sup>110</sup> There also exists a so-called loan-only credit default swap (LCDS) to cover loans made by banks.<sup>111</sup> In essence, a CDS is similar to credit insurance (though legally

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<sup>106</sup> Hull, *supra* note 71, at 704. Das, *Structured Product Volume 2: Equity; Commodity; Credit & New Markets*, at 81 (3rd ed., rev. edn, John Wiley & Sons, 2006).

<sup>107</sup> See Hull, *supra* note 71, at 552-553. As of now, weather derivatives are no longer limited to an index of temperature. Weather indices have been developed for snowfalls, frosty days and hurricanes for the weather products traded in the Chicago Mercantile Exchange. See <<http://www.cme.com/trading/prd/weather/>> (visited on 14 August 2007).

<sup>108</sup> For example, a forward freight rate swap in *Dampskibsselskabet "Norden" A/S v Andre & CIE SA* [2003] 1 Lloyd's Rep 287; *AWB (Geneva) SA v North America Steamships Ltd* [2007] EWCA 1167 (Comm). Henderson describes the application of derivative techniques to such new areas as the fourth wave of innovation. Henderson, *supra* note 43, Chapter 3.

<sup>109</sup> Das defines credit derivatives as "a class of financial instrument, the value of which is derived from an underlying market value driven by the credit risk of private or government entities other than the counterparties to the credit derivative transaction itself." Das, *Credit Derivatives: CDOs & Structured Credit Products*, at 6 (3rd edn, John Wiley, Singapore 2005).

<sup>110</sup> This is called a portfolio or basket credit default swap. See *Deutsche Bank AG v Ambac Credit Products*, 2006 US Dist LEXIS 45322.

<sup>111</sup> See Barlam, "Loan-Only Credit Default Swaps" (2007) 22(1) JIBFL 16.

speaking, a CDS may not be defined as “insurance”—see 2.5.3 below) as it protects a creditor from potential default (or other credit events).

Many new derivatives products are launched each year, and new contracts or products are often combinations of several previous products. Some major exchanges also attempt to provide standardised versions of interest rate swaps<sup>112</sup> or credit default swaps<sup>113</sup>. Some products can be further securitised (see 2.2.2.4).

#### **2.2.2.4 Hybrid and Securitised Instruments**

Market participants can also incorporate derivative techniques into existing types of investment vehicles, and thus make “hybrid” derivatives. An example is the catastrophe bond (CAT bond), where, instead of shifting risks by way of traditional reinsurance, an insurer can hedge risks originating from a catastrophic event by issuing a catastrophe bond. The bond issuer receives money from investors. If the catastrophic event does not occur, the catastrophe bond is similar to a normal bond, with periodic interest payments and a final principal repayment. However, if the event does occur, the bond issuer can deduct an amount from the principal that is returned to the bondholder. Thus, risks from a catastrophic event can be transferred from an insurer (as bond issuer) to the investors.<sup>114</sup> Hybrid instruments raise certain other problems as they are not based on single bilateral contracts but are in essence securities (or other instruments) with additional hedging or speculative functions incorporated into them.

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<sup>112</sup> For example, the CBOT provides interest rate swap futures that refer to swap rates. See <[http://www.cbot.com/cbot/pub/cont\\_detail/0,3206,1562+39888,00.html](http://www.cbot.com/cbot/pub/cont_detail/0,3206,1562+39888,00.html)> (visited on 22 May 2007).

<sup>113</sup> The alleged “CDS futures” traded on Eurex are actually futures contracts on iTraxx indices, which are published as a market benchmark to determine the price of a credit default swap. See <[http://www.eurexchange.com/trading/products/CRD\\_en.html](http://www.eurexchange.com/trading/products/CRD_en.html)> (visited on 22 May 2007).

<sup>114</sup> See Das, *Structured Products Volume 2: Equity; Commodity; Credit & New Markets*, at 1212 *et seq.* (3rd ed. rev edn, John Wiley & Sons, 2006); Hull, *supra* note 71, at 556-557. An insurer can use a combination of the CAT bond and traditional reinsurance contract to cover his potential liability.

### 2.2.2.5 Risks of Derivative Instruments

Even though derivative instruments are powerful tools for risk management, they are not free from all risk exposure. Thus, a dealer or user is also exposed to a certain degree of risk by entering into a derivative transaction. The amount that a market participant might lose varies product by product. For example, the maximum amount an optionholder can lose is the premium of the option:<sup>115</sup> but, the seller (writer) of an option is exposed to virtually unlimited losses, if the market price moves in an unexpected direction.

Various risks arise during derivatives trading.<sup>116</sup> First, derivatives are exposed to market risk. As was discussed earlier, a buyer may use a forward contract to lock the prices of a commodity, but the forward contract might become a burden if the actual future price falls below the current prices (see 2.2.2.2 above). Some of the cases outlined below are testimonials as to why it is unwise to ignore the might of the market.

Secondly, since derivative instruments are based on contracts, they are exposed to credit risk. In Henderson's words, "[d]erivatives convert other existing risks into credit risk."<sup>117</sup> The general lines of how market participants control credit risk from derivative transactions cannot be discussed here due to lack of space.<sup>118</sup> However, controlling credit risk is an important issue for all derivative traders. Apart from providing collateral, it is also possible to use credit insurance to

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<sup>115</sup> However, it would be very different if the optionholder bought an excessive quantity of options.

<sup>116</sup> See generally, Henderson, *supra* note 43, at 9.1 *et seq.*

<sup>117</sup> Henderson, *supra* note 43, at 281.

<sup>118</sup> See generally, Hudson, *supra* note 24, Chapters 11 & 12; Henderson, *supra* note 43, Chapter 21.

reduce the credit exposure from a derivative transaction.<sup>119</sup> This has further implications for the control of systemic risk in the market.<sup>120</sup>

Thirdly, there is also liquidity risk. Liquidity risk is especially likely to arise in the case of off-exchange transactions (including OTC transactions and off-exchange hybrid instruments), where the market is less transparent and it might be more difficult for a trader to liquidate his position quickly. However, traders can also suffer from a lack of liquidity in the exchange market: it is not impossible that an exchange could fail to attract enough traders to enter the market, the results being that liquidity is literally reduced. It might also happen that a trader has a large number of positions that cannot be easily liquidated.<sup>121</sup>

Lastly, there is the operational risk in derivatives trading. Any mismanagement of records, collateral, or documentation might later cause chaos for a trader or the market as a whole. Backlogs occur when the speed of finalising documentation in the back office does not match the pace of trading at the trading desk.<sup>122</sup> A bank's failure to find credible legal opinions could also be seen as another type of operational risk.<sup>123</sup>

The risks of derivative transactions are not merely a matter for academic discussion. The dark side of derivative instruments has shown itself in several

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<sup>119</sup> For example, in *Merrill Lynch v Winterthur Swiss Insurance Co* [2007] EWHC 893 (Comm), Merrill Lynch purchased "credit indemnity insurance" from an insurance company to protect itself from credit exposure from the ISDA master agreement and certain interest collar transactions that Merrill Lynch had with a third-party company. The issue of the case was whether an event of default has occurred under the ISDA master agreement that might trigger the indemnity of the subsequent credit insurance. Merrill Lynch eventually won the case and was able to claim indemnity from the insurance company. See also Das, *supra* note 114, at 752.

<sup>120</sup> Henderson argues that derivatives may result in greater aggregated credit risk in the financial system, but he also argues that credit risk does not rise to the systemic level if non-delivery is reduced, netting agreements are enforceable, and collateralisation is effective. Henderson, *supra* note 43, at 9.20. See also Paredes, "On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission" [2006] U Ill L Rev 975, at 983.

<sup>121</sup> For example, in the early 1990s, MG Refining had to hedge over 150 million barrels of crude oil from trading contracts with its customers. When oil prices fell sharply in 1993, MG suffered huge losses from its hedging transactions. MG could not meet the margin call in the New York Mercantile Exchange (estimated at about USD 1 billion) and the losses eventually led to the downfall of the parent company, Metallgesellschaft AG. See Das, *Traders, Guns & Money: Knowns and Unknowns in the Dazzling World of Derivatives*, at 95-97 (Prentice Hall, 2006).

<sup>122</sup> See Henderson, *supra* note 43, at 16.21.

<sup>123</sup> Das, *supra* note 10, at 464 *et seq.*

cases involving spectacular losses. The credit crunch after the sub-prime mortgage crisis in the US after August 2007 is also a good example.<sup>124</sup> The victims of derivative instruments range from financial institutions, government bodies and big corporate entities to relatively small businesses and wealthy private individuals. In *BankAtlantic v Blythe Eastman Paine Webber, Inc.*,<sup>125</sup> the bank suffered losses in excess of USD 30 million from two interest rate swaps.<sup>126</sup> Orange County lost USD 1.5 billion of taxpayers' money through buying certain structured notes.<sup>127</sup> Procter & Gamble (P&G) was initially under an obligation to pay 200 million US dollars out of two highly leveraged swaps, with the Bankers Trust.<sup>128</sup> P&G eventually settled with the Bankers Trust for USD 35 million plus a USD 14 million swap.<sup>129</sup> Kwiatkowski, a wealthy individual, lost more than USD 200 million trading currency futures.<sup>130</sup>

When big losses occur, an intuitive response is to either attempt to get rid of the contract(s) or to at least seek damages from the counterparty. Legal claims (either as causes of action or defences) range from statutory violation to common law claims (such as misrepresentation, breach of contract, negligence, breach of fiduciary, etc.).<sup>131</sup> These cases provide an important interface where judges

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<sup>124</sup> See Lieberman, "Subprime Fallout: Where Do Exposures Lie?" (2007) 11 JIBFL 657; Walker, "Credit Crisis: Regulatory and Financial Systems Reform" (2007) 10 JIBFL 567.

<sup>125</sup> 12 F 3d 1045 (1994).

<sup>126</sup> BankAtlantic then unsuccessfully sued its advisor (rather than the counterparty) for failure to disclose the risks involved in the swap transactions. Unfortunately, the judgment was about Paine Webber's failure to produce documents in the proceedings rather than the merits of the case.

<sup>127</sup> Das, *supra* note 121, at 50.

<sup>128</sup> See *Procter & Gamble Co v Bankers Trust Co*, 925 F Supp 1270 (1996).

<sup>129</sup> Kokkoris, "Liability of Swaps Dealers against Users" 2006 17(2) ICCLR 63, at 70.

<sup>130</sup> See *De Kwiatkowski v Bear, Stearns & Co, Inc*, 306 F 3d 1293 (2002). Kwiatkowski then unsuccessfully brought claims against the bank for damages on the grounds of fraud, misrepresentation, negligence and fiduciary relationship.

<sup>131</sup> To take the example of a US case. In *K3C Inc v Bank of America*, 2006 US App LEXIS 27437, K3C lost a sum of money from entering interest rate swaps with the Bank of America. K3C brought exactly 11 different causes of action to the court: "(1) fraud, (2) gross negligence, (3) negligent misrepresentation, (4) breach of fiduciary duty, (5) breach of duty to disclose, (6) breach of duty to deal fairly and in good faith, (7) rescission due to misrepresentation, (8) violation of the Texas Deceptive Trade Practices Act, (9) violation of the Texas Business Opportunity Act, (10) violation of the Texas Securities Act, and (11) violation of the Bank Holding Company Act." At 2. Unfortunately for K3C, the Second Circuit Court rejected all the claims.

A similar situation might also occur when a party is a defendant in a lawsuit. For example, in *Lehman Brothers Commercial Corp v Minmetals International Non-Ferrous Metals Trading Co*, 179 F Supp 2d 118 (2000), Lehman sued Minmetals for money out of a few foreign exchange

express their views on derivative transactions. This thesis cannot provide an in-depth analysis of every claim, but later in this chapter there will be a summary of certain case laws to date (see section 2.3 below). At this stage, it is important to be aware that the powers of derivative instruments should not be taken lightly. The use or misuse of derivative instruments may eventually lead to legal battles.

### 2.2.2.6 Commoditisation of Risk and Risk Trading

Following the preceding discussion, it is clear that derivative instruments open a new door to hedge against risk exposure from future uncertainties. With the help of financial technology, the risk management strategy of today is far more advanced than a few decades ago. Nowadays, a market participant may hedge risks ranging from market and credit risks, to global warming and human life expectancies. As financial techniques develop, managing risk becomes a more complicated business.<sup>132</sup> Financial engineering has also made it possible to hedge and speculate some future uncertainties that were originally beyond the control of market participants.

In a way, derivative instruments have helped to commoditise the rather abstract concept of “risk” into something that can be bought and sold.<sup>133</sup> One can transform uncertainties into certainties or *vice versa*. Market terminology, such as “long” (buy), “short” (sell), “position” (number of contracts held) etc., also indicates the sense of commoditisation: by quantifying the possibilities of the realisation of risk, one can calculate an expected loss or gain more accurately.

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transactions and Minmetals brought 18 defences to the court: “(1) Lehman failed to state a claim upon which relief can be granted; (2) the transactions at issue were not authorized; (3) Lehman was negligent and breached its fiduciary duties; (4) Lehman inequitably failed to advise Non-Ferrous of the risks of the transactions at issue; (5) Lehman committed fraud and misrepresentation; (6) the transactions at issue were illegal; (7) Lehman's claims are barred by the doctrine of unclean hands; (8) Lehman provided information that was incorrect and misleading; (9) Lehman breached the contracts at issue; (10) the contracts at issue lack consideration; (11) Lehman's claims are barred by the doctrines of mutual or unilateral mistake; (12) the transactions were in violation of the Commodity Exchange Act ...; (13) Lehman's claims are barred by the doctrines of estoppel and equitable estoppel; (14) Lehman's claims are barred by the doctrine of laches; (15) Lehman's claims are barred by the doctrine of waiver; (16) Lehman failed to mitigate its damages; (17) this Court lacks personal jurisdiction over the Defendants; and (18) in essence, Lehman acted unfairly and deceitfully.” at 133.

<sup>132</sup> See generally, Das, *supra* note 10.

<sup>133</sup> Professor Walker also describes it as the “deconstruction of financial risk”. See Walker, “Credit Crisis: Regulatory and Financial Systems Reform” (2007) 10 JIBFL 567.



As more data (about all aspects) has accumulated over the past decades, merchants have developed a greater ability to calculate risk on the basis of past performances and to look for potential gains. In the confines of this text, this will be called the process of “commoditisation of risk”.<sup>134</sup>

## 2.3 Overall View of Legal Disputes about Derivatives

In this section, we will briefly review case laws of the past two decades relating to derivative transactions mainly in the UK but also in the US. First we will introduce a series of local authority cases from the UK. There will also be an overview of contractual lawsuits relating to derivative instruments and the so-called “suitability” issues and the liability of derivative brokers/dealers. A reader should bear in mind that the following categorisation is made for the convenience of discussion only, and not based on legal causes of actions.

### 2.3.1 Local Authority Cases in the UK

There arose several lawsuits involving the use of interest rate swaps by certain local authorities in the UK. In the 1980s, it was popular for certain local authorities in the UK to enter into interest rate swaps with banks. Then, one of the auditors of the Hammersmith council brought a claim to court arguing that these interest rate swaps were not allowed by the Local Government Act 1972. In *Hazell v Hammersmith and Fulham London Borough Council*,<sup>135</sup> the House of Lords held that interest rate swaps entered into by local authorities were *ultra vires* and thus void *ab initio*.

It is interesting to note that several interest rate swaps entered into by local authorities involved an upfront payment by a counterparty bank, which would

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<sup>134</sup> This process is also noticed by the industry. See speech of Peter Fisher, Executive Vice President of New York Federal Reserve Bank in 1998  
<<http://www.ny.frb.org/newsevents/speeches/1998/pf981015.html>> (visited on 10 August 2006).

<sup>135</sup> [1992] 2 AC 1.

then be balanced by an adjustment of the parties' respective liabilities. It was found that:

“[t]he practical result of this is to achieve a form of borrowing. It appears that it was this feature which, in particular, attracted local authorities to enter into transactions of this kind, since they enabled local authorities subject to rate-capping to obtain upfront payments uninhibited by the relevant statutory controls, though they must in the process have been storing up trouble for themselves in the future.”<sup>136</sup>

After the *Hazell* judgment, the issue was whether a party (usually a bank) in an interest rate swap which involved a local authority could recover the money it had paid to the other party. This in turn led to the question as to whether there must be a total failure of consideration to trigger unjust enrichment,<sup>137</sup> and whether one party could recover money on the ground of mistake of law.<sup>138</sup> The House of Lords also had to address the issue of whether there was a resulting trust (so as to establish an equitable proprietary claim) between the parties after a swap had been declared void.<sup>139</sup> If recovery was allowed, then the next question was whether compounded interest should be granted.<sup>140</sup> In some cases, limitation became a major issue, which was also related to the mistake of law argument.<sup>141</sup> In addition, the recovery claim was not limited to transactions that were still “open” (i.e. swap agreements not yet completely executed). Restitution claims also arose for completely executed transactions (“closed swaps”).<sup>142</sup>

In general, restitution claims were allowed, for both the open and closed swaps.<sup>143</sup> In a close decision, the compound interest claim was rejected.<sup>144</sup> In another close decision, the recovery of money was allowed for a payment made

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<sup>136</sup> *Kleinwort Benson Ltd v Lincoln City Council* [1999] 2 AC 349, at 362 (per Lord Goff).

<sup>137</sup> *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669; *Kleinwort Benson Ltd v Birmingham City Council* [1997] QB 380.

<sup>138</sup> *Kleinwort Benson Ltd v Lincoln City Council* [1999] 2 AC 349.

<sup>139</sup> *Westdeutsche Landesbank*, *supra* note 137.

<sup>140</sup> *Id.*

<sup>141</sup> *Kleinwort Benson Ltd v Lincoln City Council* [1999] 2 AC 349; *Kleinwort Benson Ltd v Glasgow City Council* [2002] SLT 1190.

<sup>142</sup> *Kleinwort Benson v Sandwell Borough Council* [1994] 4 All ER 890; *Guinness Mahon & Co Ltd v Kensington and Chelsea Royal London Borough Council* [1999] QB 215.

<sup>143</sup> *Id.*; *Westdeutsche Landesbank*, *supra* note 137.

<sup>144</sup> *Westdeutsche Landesbank*, *supra* note 137.

under mistake of law.<sup>145</sup> The defence of “passing on” was rejected in one case so the claimant did not need to suffer substantive losses in order to claim unjust enrichment.<sup>146</sup> However, the House of Lords found no resulting trust between a bank and a local council to support an equitable proprietary claim.<sup>147</sup> In one case, a party argued that interest rate swaps were a type of gaming or wagering, but the argument was rejected.<sup>148</sup>

This series of local authority cases contributed greatly to the development of the law for restitution and equity in the UK and incited academic debate in this area.<sup>149</sup> We will not join the debate about restitution, mistake, compound interest and equity in these judgments (or how the same issues might be resolved in other jurisdictions), as they are outside the scope of this thesis. However, there are certain points in the local authority cases that we may indicate.

First, the local authority cases illustrate the complexity of legal issues that may occur when a derivative instrument is set aside, particularly for transactions with multiple performances (such as an interest rate swap). Thus, it might be argued that it is better to refrain from avoiding a derivative transaction so as not to raise legal problems like those seen in the local authority cases. This thesis makes two responses to this argument. On the one hand, it is one thing for a party to avoid a contract by applying an existing legal doctrine (such as misrepresentation or undue influence). So we should not reject the application of a doctrine

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<sup>145</sup> *Kleinwort Benson Ltd v Lincoln City Council* [1999] 2 AC 349.

<sup>146</sup> *Kleinwort Benson Ltd v Birmingham City Council* [1997] QB 380.

<sup>147</sup> *Westdeutsche Landesbank*, *supra* note 137.

<sup>148</sup> *Morgan Grenfell & Co Ltd v Welwyn Hatfield District Council* [1995] 1 All ER 1. See also *infra* 4.1.1.

<sup>149</sup> See for example, Hudson, *Swaps, Restitution, and Trusts* (Sweet & Maxwell, 1999); Hudson, *supra* note 24, at 7-25 *et seq.*; Burrows, “Swaps and the Friction between Common Law and Equity” (1995) RLR 15; Swadling, “Restitution for No Consideration” (1994) RLR 73; Birks, “No Consideration: Restitution after Void Contracts” (1993) 23 WALR 195; Giglio, “A Systematic Approach To ‘Unjust’ And ‘Unjustified’ Enrichment” (2003) 23 OJLS 455; Burrows, “We Do This at Common Law but That in Equity” (2002) 22 OJLS 11; Chen-Wishart, “Unjust Factors and the Restitutionary Response” (2000) 20 OJLS 557; McCormack, “Proprietary Claims and Insolvency in the Wake of *Westdeutsche*” (1997) JBL 48; Cohen “Is Equity Sterile? No Award of Compound Interest in Local Authority Swaps Litigation” (1996) 11(9) JIBL 347; Cohen, “Swaps, Restitution and Compound Interest: *Westdeutsche Landesbanke v Islington*” (1995) 10(3) JIBL 105; Cope, “Compound Interest and Restitution” (1996) 112 LQR 521; Gretton, “Swap and Unjust Enrichment” (1996) JBL 327; Jones, “Ultra Vires Swaps: the Common Law and Equitable Fall-out” (1996) 55(3) CLJ 432; Stallworthy, “Restitution” (1993) 11(12) IBFL 133.

merely because there would be complicated legal issues afterwards. On the other hand, it is another to discuss whether it is feasible to create a legal concept or extend an existing one (e.g. the doctrine of disclosure as discussed in Chapter 5) to derivative instruments. Potential legal consequences and complexities are important aspects of the different solutions to such a problem.

Secondly, the doctrine of *ultra vires* is not without concern for market participants. No comment will be made as to whether a government entity should be able to use taxpayers' money to conduct derivatives trading, as this subject involves policy concerns beyond the scope of this thesis.<sup>150</sup> If a market participant is organised as a company, the Companies Act 2006 provides that "[t]he validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's constitution".<sup>151</sup> Also, the law might make it clear that the violation of rules which restrict a certain type of institution to enter into derivative transactions would not invalidate any transaction;<sup>152</sup> nevertheless, where no such clarification exists, the validity of a transaction may still be called into question on the ground of *ultra vires*.

Lastly, a derivative transaction could become a tool for evading rules that restrict what an institution can or cannot do. For example, in *Korean Life Insurance Co, Ltd v Morgan Guaranty Trust Company of New York*,<sup>153</sup> both parties entered, through their subsidiaries, into a complex transaction that involved at least five different corporate entities and a combination of a shares subscription, a purchase of certificates of deposit, total return swaps and a guarantee. In short, the Korean Life Insurance (KLI) acquired additional finance that was not usually

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<sup>150</sup> See Loughlin, "Innovative Financing in Local Government: the Limits of Legal Instrumentalism: Part 1" (1990) PL 372; Loughlin, "Innovative Financing in Local Government: the Limits of Legal Instrumentalism: Part 2" (1991) PL 568; Aisbett, "Participation of Local Authorities in the Capital Markets and the Hammersmith Case" (1990) 5(1) JIBL 33; Ayres and Polglase, "The Ultra Vires Doctrine as Applied to Swaps" (1989) 4(12) JIBFL 537; Newman, "Local Authorities and the Capital Markets: the Decision of the House of Lords in the Hammersmith Case" (1990) 5(12) JIBL 503.

<sup>151</sup> Companies Act 2006, section 39.

<sup>152</sup> For example, Building Societies Act 1986, section 9A (inserted by Building Societies Act 1997, section 10); see also FSA Handbook, INSPRU 3.2.5, ELM 3.7; Financial Services and Markets Act 2000, section 151(2). See *infra* Appendix 1 for the statutory texts.

<sup>153</sup> 269 F Supp 2d 424 (2003).

available to it under Korean insurance laws. The purpose of the whole undertaking was found to be “to mask the transaction from Korean regulators”.<sup>154</sup> The US court only dealt with KLI’s contractual claims and thus did not answer the question of whether the whole transaction might be void (for reasons of *ultra vires* or on other grounds) under Korean law. However, regulators undoubtedly have a clear interest to uncover such disguised transactions.<sup>155</sup>

In sum, the local authority cases illustrate how complicated legal issues might become when a derivative transaction is rendered void. It is too early to argue that the local authority cases have resolved all potential issues or provided clear guidelines for market participants. However, these judgments provide a basis on which a market participant might draft a term or design a contractual structure to minimise potential *ultra vires* or other claims that might influence the validity or enforceability of a transaction. Judges and practitioners might take note from these cases and resolve to improve their documentation.

### 2.3.2 Contractual Claims

Since derivative instruments are based on contracts, they are not free from contractual dispute, which may arise from breach of contract or differing interpretations of contractual terms. The following is not a complete list of the current case laws in the UK and US regarding contractual claims related to derivative transactions, but rather a select class of cases that may shed some light on what has happened so far.

First, let us examine a couple of cases dealing with the calculation of damages after a breach of contract for a derivative transaction has occurred. It has been held that it is proper to calculate damages for a breach of contract according to the price differences between the original swap and a replacement swap, if a market is available.<sup>156</sup> Another relevant question is whether a party may claim costs of (or losses from) related hedging transactions as damages for the breach of an

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<sup>154</sup> *Id.*, at 427.

<sup>155</sup> See Partnoy, “Financial Derivatives and the Costs of Regulatory Arbitrage” (1997) 22 Iowa J Corp L 211.

<sup>156</sup> *Dampskibsselskabet “Norden” A/S v Andre & CIE SA* [2003] 1 Lloyd’s Rep 287.

underlying sale of goods or loan agreement. In other words, the issue is whether the loss of hedge is too remote to be allowed. English courts have awarded damages for the costs of a hedge caused by the late delivery of crude oil,<sup>157</sup> and English law also allows a non-defaulting seller to resell in the futures market if it is a reasonable way to mitigate his losses.<sup>158</sup> However, a US court has refused to grant damages for costs to unwind a hedge owing to a party's failure to apply for a loan.<sup>159</sup> These cases may not arise directly out of a derivative transaction: however, as derivative instruments gain in popularity, damages and losses from hedging transactions will become important issues for contract law in the future.

Secondly, standard forms are not exempt from contractual disputes, even the most popular form published by the International Swaps and Derivatives Association (ISDA). Disputes arose as to the choice of "market quotation" and "loss" after an early termination in the 1992 ISDA form.<sup>160</sup> One dispute related to whether a transaction was rightfully terminated.<sup>161</sup> Another concerned a condition precedent to payment and an exclusive jurisdiction clause.<sup>162</sup> These cases may help us to further improve the clarity of standard documentation.

Thirdly, quite a few lawsuits have come about in relation to credit derivatives, especially credit default swaps (see 2.2.2.3 above). Disputes have taken place over the meaning of "credit event" and whether a particular event falls within the scope of the "credit event" as defined in the contract.<sup>163</sup> In some cases, it is the lack of clarity of the contractual terms or poor drafting of the contract that raised the question as to whether a credit event actually occurred.<sup>164</sup> Moreover, an

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<sup>157</sup> *Addax Ltd v Arcadia Petroleum Ltd* [2000] 1 Lloyd's Rep 493.

<sup>158</sup> *Gebrüder Metelmann GmbH & Co KG v NBR (London) Ltd* [1984] 1 Lloyd's Rep 614.

<sup>159</sup> *Nationwide Life Insurance Co v St Clair Mobile Home Parks, LLC*, 2006 US Dist LEXIS 82965.

<sup>160</sup> See *Australia and New Zealand Banking Group Ltd v Société Générale* [2000] 1 All ER (Comm) 682; *Peregrine Fixed Income Ltd v Robinson Department Store Public Co Ltd* [2000] Lloyd's Rep Bank 304.

<sup>161</sup> *Nuova Safim SpA v Sakura Bank Ltd* [1999] 2 All ER (Comm) 526.

<sup>162</sup> *AWB (Geneva) SA v North America Steamships Ltd* [2007] EWCA 1167 (Comm). The dispute is pending on further English judgment on the construction of relevant terms in the ISDA form.

<sup>163</sup> See *Deutsche Bank AG v ANZ Banking Group Ltd* 2000 WL 1151384; *Eternity Global Master Fund Ltd v Morgan Guaranty Trust Co of New York*, 375 F 3d 168 (2004).

<sup>164</sup> For example, *Aon Financial Products, Inc v Société Générale*, 476 F 3d 90 (2007) and *URSA Minor Ltd v Aon Financial Products, Inc*, 7 Fed Appx 129 (2001). The factual background of

English court once held that a convertible bond was not “subject to contingency” and was deliverable under the 1999 ISDA Credit Definitions.<sup>165</sup> Meanwhile, in the US, a bank lost its breach of contract claim (for money) because it failed to deliver the underlying bond within the timeframe specified by the contract.<sup>166</sup>

Finally, like other contracts, contractual disputes about derivative transactions may arise in relation to the formation, validity, performance, or breach of contract. One dispute as to the incorporation of the standard form of contract occurred when an agreement was reached by telephone.<sup>167</sup> Another took place in reference to the date of exercising an option.<sup>168</sup> Of course, disputes have also erupted regarding the choice of law and forum selection.<sup>169</sup> A complete accounting of such judgments cannot be provided within the confines of this thesis, but, there may be indications in passing that more and more contractual lawsuits are being generated. While the above judgments have not actually created new common law doctrines, they have helped to improve the standard documentation and the contractual negotiation of derivatives (particularly OTC transactions).

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the two cases is related. Aon entered into a credit default swap with the plaintiff in *URSA* and agreed to pay against the failure of one Philippine government agency to honour the surety bonds the agency issued. Aon then entered into a second credit default swap with Société Générale to hedge its exposure in the first swap. The two swaps have a similar but slightly different term to define the “credit event”. The Philippine agency then refused to honour the surety bonds by claiming that the bonds were invalid. In the end, Aon was obliged to pay under the first swap in *URSA*, as a credit event was held to have occurred. However, Aon failed to recover its money under the second swap, as the Second Circuit Court held that a credit event had not been triggered in *Aon Financial Products* (2007). In sum, the supposed-to-be back-to-back swaps did not work for Aon because of the different credit event terms in the two swap agreements.

<sup>165</sup> *Nomura International plc v Credit Suisse First Boston International* [2003] 2 All ER (Comm) 56.

<sup>166</sup> *Deutsche Bank AG v Ambac Credit Products*, 2006 US Dist LEXIS 45322. The US court rejected Deutsche Bank’s argument that industrial practices allowed more flexibility over the time of delivery than their contract required. Instead, the court found there was a reason that the time of delivery for a CDS had be strictly specified and enforced.

<sup>167</sup> *Crédit Suisse Financial Products v Société Générale d’Enterprises* [1997] CLC 168.

<sup>168</sup> *See Caisse Nationale de Credit Agricole v CBI Industries, Inc*, 90 F 3d 1264 (1996).

<sup>169</sup> *See Royal Bank of Canada v Cooperative Centrale Raiffeisen-Boerenleenbank BA* [2004] 1 Lloyd’s Rep 471; *Erne Shipping Inc v HBC Hamburg Bulk Carriers GmbH*, 409 F Supp 2d 427 (2006).

### 2.3.3 Suitability Claims

Another class of lawsuits involves what this thesis broadly calls “suitability” claims, or, in other words, the liability of derivative brokers/dealers. Since derivative instruments are still risky by nature, it is arguable whether the seller of a derivative instrument should take more responsibility for entering into a derivative transaction with a client. Suitability claims raise two questions. On the one hand, such claims might come directly from the violation of statutory suitability rules; on the other, a market participant might still seek protection on other common law grounds. In this section, we will briefly discuss these two aspects with reference to certain existing UK case laws.

Under UK law there is an obligation of “suitability” under the rules of the Financial Services Authority (FSA).<sup>170</sup> Under current rules, an investment firm should take reasonable steps to ensure that its advice to a client is suitable when it makes any personal recommendation to buy or sell “designated investment”.<sup>171</sup> In addition, a firm must assess the appropriateness of its client when providing investment services, and must warn the client if the firm considers that the investment is not appropriate for them.<sup>172</sup> However, the firm’s obligation might be reduced if the client is considered a “professional client”.<sup>173</sup> It is interesting to note that there are few lawsuits pertaining to the suitability rule, though the violation of such a rule is actionable for damages<sup>174</sup>. For comparison purposes, the suitability rule in the US comes from rules of self-regulatory bodies<sup>175</sup> rather than federal or state laws. It is arguable whether an investor may sue a firm for damages for the violation of the suitability rule of a self-regulatory body.<sup>176</sup>

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<sup>170</sup> See FSA Handbook, PRIN 2.1.1 (Principle 9); FSA Handbook, COBS 9.

<sup>171</sup> See FSA Handbook, COBS 9.

<sup>172</sup> See FSA Handbook, COBS 10.

<sup>173</sup> See FSA Handbook, COBS 10.2.1(2)(b). See also FSA Handbook, COBS 3 for classification of clients under the new conduct of business rules.

<sup>174</sup> FSMA 2000, section 150.

<sup>175</sup> See for example, NASD Rule 2860(b)(19)(A); NFA Compliance Rules, Rule 2-30(4).

<sup>176</sup> See *Merrill Lynch, Pierce, Fenner & Smith, Inc v Goldman*, 593 F 2d 129 (1979); *Avern Trust v Clarke*, 415 F 2d 1238 (1969). However, contradictory authority also exists. *Regina (Rega) Jablon v Dean Witter & Co*, 614 F 2d 677 (1980).



However, in certain circumstances failing to ensure the suitability of a client might violate the anti-fraud provision of the Securities Exchange Act of 1934.<sup>177</sup>

In *Morgan Stanley UK Group v Puglisi Cosentino*<sup>178</sup>, Mr. Puglisi (P), a wealthy Italian, claimed that Morgan Stanley (MS) breached the suitability rule of the then Securities Association (TSA) when selling a structured product called a “principal exchange rate linked security” (PERLS),<sup>179</sup> which then lost a large part of its value after a series of events in the 1990s. MS requested P to repurchase the PERLS as they had previously agreed upon but P refused. MS then sold the PERLS in the market and claimed the difference between the repurchase and resale prices (roughly USD 6.6 million). P counterclaimed that MS had violated the suitability and risk warning rule of the then Securities Association (TSA). Longmore J held that the PERLS was a kind of “contract for differences” that would trigger the TSA rules. In addition, MS had agreed that P should be classified as a “private customer”. Longmore J eventually held that the PERLS was not suitable for P, though he did not really define the meaning of the term “suitability”.

As Hudson observes, Longmore J seemed to suggest a “double-barrelled concept of suitability: first, the means by which the product is sold must be suitable and secondly, the substance of the product which is sold must itself be suitable”.<sup>180</sup>

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<sup>177</sup> For example, it might be a violation of the anti-fraud clause (section 10(b)) of the US Securities Exchange Act of 1934 if a person solicited unknown persons to buy securities without any attempt to determine the financial position or investment needs of such persons (a so-called “boiler-room” operation). For example, *see SEC v RJ Allen & Associates, Inc.*, 386 F Supp 866 (1974). *See also Brown v EF Hutton Group, Inc.*, 991 F 2d 1020 (1993). In *EF Hutton*, some 400 plus investors lost money on a limited partnership and subsequently brought claim against the defendant alleging that the defendant breached the anti-fraud provision by representing that investment in the partnership was suitable for the investors. This created the so-called “unsuitability fraud” claims. However, the court in *EF Hutton* found that the legal documents clearly stated the nature and risk of the product and thus investors could not lawfully rely on this representation so that the fraud claim failed. The *EF Hutton* case is not directly applicable to products that do not fall within the definition of “security” under the Securities Act of 1933 or the Securities Exchange Act of 1934. In *Lehman Brothers Commercial Corp v Minmetals International Non-Ferrous Metals Trading Co.*, 179 F Supp 2d 159 (2001), the Second Circuit court rejected the claimants’ argument that there was a common law unsuitability claim.

<sup>178</sup> [1998] CLC 481.

<sup>179</sup> The PERLS was a fixed interest US dollar bond whose redemption value would exceed the principal amount if the hard currencies depreciated and would be less than the principal amount if they appreciated.

<sup>180</sup> Hudson *supra* note 24, at 7-16.

The substantive aspect of “suitability” was reflected in Longmore J’s description that the PERLS was considerably greater than any of P’s other investments and that P was at considerable risk finding money every 6 months to meet MS’s repurchase demand. The procedural aspect was shown by the fact that MS did not present the transaction properly and that several key documents were not sent to P before the transaction.

Outside the application of the FSA’s suitability rule, lawsuits may arise in circumstances where a firm fails to do something (usually to provide ongoing advice or warn of the risk of a transaction). This constitutes another aspect of the “suitability” issue. As there is no general doctrine of suitability in common law, a claimant often resorts to claims of fraud, misrepresentation, breach of fiduciary duty and breach of a tortious duty of care as causes of actions.

In *Bankers Trust International plc v PT Dharmala Sakti Sejahtera*,<sup>181</sup> PT Dharmala Sakti Sejahtera (DSS) entered into two interest rate swaps with the Bankers Trust (BT). The parties performed the first swap (“swap 1”) in January 1994, but soon replaced it with a second swap (“swap 2”), under which DSS “would receive interest at the six-month US dollar LIBOR rate plus 1.25 per cent per annum, and would pay interest at the six-month LIBOR rate less 2.25 per cent per annum ‘plus spread’”.<sup>182</sup> Unfortunately for DSS, the LIBOR<sup>183</sup> continued to rise in the following months and DSS suffered losses. Upon BT’s action for money, DSS counterclaimed for lack of authority, misrepresentation, breach of contract, and breach of duty of care.

DSS made a long list of charges of false representation, and a large part of the judgment was a lengthy examination of the evidence and facts. As to swap 1, Mance J held that

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<sup>181</sup> [1996] CLC 518.

<sup>182</sup> [1996] CLC 518, at 520-521. The trick was that the “[s]pread was to be zero, if the six-month LIBOR rate did not go above 5.25 per cent per annum at any time during a ‘look’ period consisting of the next year. If the rate did go above that level (or ‘barrier’) *at any time* during the next year, spread was to be established for each of the two years of swap 2 by taking whatever was the six-month LIBOR rate (called ‘rate’ in the proposal) at the year end”. At 521.

<sup>183</sup> LIBOR is the acronym of “London Interbank Offered Rate”, one of the most popular benchmark for interest rates.

“there is no basis upon which [BT] ... can in my judgment be said to have represented that swap 1 was ‘suitable’ or ‘safe’ for DSS, or that the only relevant historical rates for six-month LIBOR were those in Appendix 6 or that it was intended to replace swap 1 ‘at no cost’ if the barrier was reached. [BT] did pass on and provide ... economic forecast stay below the barrier in the relevant swap year. The only representation made was that this was a reasonable forecast, based on proper research and reasonable grounds, as it was.”<sup>184</sup>

Mance J was more critical of BT’s practice regarding swap 2. Mance J distinguished two issues: whether a representation is false and whether DSS was indeed misled by the representation. Mance J found that the quality of BT’s sales presentation was probably not high; however, DSS held itself out as a sophisticated investor and was capable of evaluating and looking after its own position. Thus, DSS was held not to have been misled by BT’s representation and DSS’s misrepresentation claim was rejected.<sup>185</sup>

As to the duty of care claim, two of DSS’s arguments were quite interesting: on the one hand, DSS argued that BT failed to give adequate warning to DSS as to the risks for DSS inherent in each proposed swap; and on the other, BT failed to consider or advise DSS as to the desirability of achieving its stated objectives using a range of different products or transactions and not just by the two proposed swaps.<sup>186</sup>

Mance J held that

“[DSS raised] the question to what extent a duty should be recognised requiring [BT] to warn DSS about the wisdom or unwisdom of this type of speculative transaction. Again, this was not in my view a role which DSS can or would have expected or have been entitled to expect [BT] to fulfil.”<sup>187</sup>

Mance J further held that “

“I have considered whether [BT] should be regarded as under a duty ... to disclose this adverse current market value to DSS. ... I accept that it would, if disclosed, have been likely to cause DSS to think very hard about swap 2. The fact remains that this is not information of a nature which anyone at

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<sup>184</sup> *Id.*, at 555. \_

<sup>185</sup> *Id.*, at 573.

<sup>186</sup> *Id.*, at 528.

<sup>187</sup> *Id.*, at 575.

the time would have expected to be disclosed before such a transaction. DSS in particular never sought any information or assurances about [BT's] profit or about the possibility or cost of reversal of either swap before entering into either. Each swap was entered into as a longer term speculation, and with a view to awaiting events and profiting (or, if the worst occurred, losing) according to the actual movements of rates over the next year. Neither swap was entered into with a view to reversing or trading the transaction on the current market at an earlier stage.”<sup>188</sup>

In the end, Mance J rejected all of DSS's claims. Mance J raised an important principle that, if a party is capable of evaluating the transaction (or like DSS, holding itself out as a sophisticated investor), the counterparty may not be said to have been misled by the misrepresentation (if any). In short, if a transaction appears to be within arm's length, the court normally does not intervene. The quality of BT's presentation was far from perfect, but Mance J did not find it to constitute misrepresentation or a further breach of a tortious duty of care.

*Dharmala* was not a lone decision. In *Peekay Intermark Ltd v Australia and New Zealand Banking Group Ltd*,<sup>189</sup> the ANZ led Peekay to believe that the transaction it was entering into conferred an interest in Russian treasury bonds. However, the transaction was in fact a structured deposit, as was stated in the Final Terms and Conditions (FTCs). What makes this case interesting is that Peekay only glanced through the FTCs and signed a risk disclosure document without checking the details. After realising the real nature of the investment, Peekay sued ANZ for misrepresentation. In the first instance, Richard Siberry QC held that the true nature of the transaction was misrepresented because it was very different from what ANZ told Peekay.<sup>190</sup> In the Court of Appeal, Moore-Bick LJ took a different view of whether or not Peekay relied on ANZ's representation. Moore-Bick LJ agreed that ANZ did to some extent misrepresent the nature of the transaction during negotiation. However, as the High Court judge also found, the information given before the FTCs was merely “rough and ready”. Thus, the FTCs were “the first and only opportunity that [Peekay] was given to satisfy himself that the nature of the investment and the

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<sup>188</sup> *Id.*

<sup>189</sup> [2006] 2 Lloyd's Rep 511.

<sup>190</sup> [2005] 2 CLC 111, at 142.

terms relating to it were consistent with the broad description [given by ANZ].”<sup>191</sup> Therefore, Moore-Bick LJ held that Peekay was not induced to enter into the transaction by ANZ’s misrepresentation, but “by [its] own assumption that the investment product to which they related corresponded to the description [it] had previously been given.”<sup>192</sup> As for the risk disclosure statement, Moore-Bick LJ held that by signing the statement Peekay confirmed that it understood the nature of the transaction. Since ANZ had not misrepresented the FTCs and the risk disclosure statement, Peekay was estopped from claiming that it had been induced by ANZ’s earlier representation of the nature of the transaction.<sup>193</sup>

The *Peekay* case reflects the tension between the misleading nature of ANZ’s representation and Peekay’s ignorance. On the one hand, ANZ did not promote its product properly as Peekay was not the only customer complaining about this product.<sup>194</sup> But, on the other hand, Peekay’s total ignorance when signing contractual documents was inexcusable. The High Court preferred to protect Peekay from ANZ’s sale practices; but the Court of Appeal preferred to have Peekay take more responsibility for its own behaviour.

There are also several US judgments dealing with similar issues. Like English courts, US judges were also reluctant to impose a fiduciary or tortious duty of care on a derivative broker/dealer to provide ongoing advice or to provide risk warnings.<sup>195</sup> In short, both the UK and US courts have shown a reluctance to intervene in arm’s length transactions. However, we should be aware that neither UK nor US law rules out the possibility that there could be a fiduciary duty of care between parties to a derivative transaction if there is a special circumstance existing (see 5.4.1 below). As to the tort of negligence, we may assume that a client’s loss is probably foreseeable and that the relationship

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<sup>191</sup> [2006] 2 Lloyd’s Rep 511, at 522.

<sup>192</sup> *Id.*, at 522.

<sup>193</sup> *Id.*, at 522–523.

<sup>194</sup> [2005] 2 CLC 111, at 132.

<sup>195</sup> See *De Kwiatkowski v Bear, Stearns & Co, Inc*, 306 F 3d 1293 (2002); *K3C Inc v Bank of America*, 2006 US App LEXIS 27437; *Power & Telephone Supply Company, Inc v Suntrust Banks, Inc*, 447 F 3d 923 (2006).

between parties is proximate enough. Thus, the issue would then depend on whether it is “fair, justice and reasonable” to impose a duty of care.<sup>196</sup>

This thesis takes the position that, given the risky nature of derivative transactions, the suitability issue will be tested further in the future in both the UK and US courts. While this thesis cannot afford to examine the judgments in full, we believe that these judgments also send a signal to market participants about how derivative transactions should be promoted and what clients can do to protect themselves. Perhaps another scandal or economic downturn is needed in order to bring more cases to court. The subprime crisis and credit debacle occurring since August 2007 might also result in more cases in the years to come. If this should happen, then we will see the next round of cases where judges are forced to consider the suitability issue and the relationship between a derivative seller and a client.

## 2.3.4 Characterisation: An Overview

In the commoditisation process, we may see derivative instruments (exchange-traded or OTC) as contracts to trade risks. Seeing derivative instruments as risk trading contracts does not alter the fact that derivative instruments might be used for purposes other than hedging and speculation.<sup>197</sup>

As derivative instruments may be settled in cash or even by the physical delivery of goods, they may be used for commercial/hedging purposes or purely for speculation, and may be standardised or non-standardised (see 1.1 above). It then provides several ways by which “risk trading contracts” might intrude on other existing types of contracts. This raises the key question of this thesis: what is the contractual nature of derivative instruments? This question evokes not only private law issues (e.g. the application of insurance contract law) but also regulatory problems. The effects of private law might be minimal, as the

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<sup>196</sup> See *Customs and Excise Commissioners v Barclays Bank plc* [2007] 1 AC 181; *Caparo Industries plc v Dickman* [1990] 2 AC 605.

<sup>197</sup> Apart from hedging and speculation, derivative instruments could also be used for asset management or for arbitraging market prices. See generally, Hudson, *supra* note 24, at 2-11 *et seq.*

common law in general places less emphasis on special contracts. However, the question as to whether a derivative instrument belongs to a regulated type of contract is more serious, because a transaction may be rendered void and unenforceable if it is of a regulated kind and a party has not obtained proper authority or a licence from regulators.<sup>198</sup>

Therefore, there are claims that a derivative instrument may be invalid or unenforceable if it can be defined as an existing type of contract/instrument that is either prohibited or regulated (if a person does not acquire the proper licence from a regulator).<sup>199</sup> This is often called “recharacterisation risk”.<sup>200</sup> It also reflects the fact that the law regarding instruments that involve a certain degree of future uncertainty is fragmented.

UK law is relatively simple, as the Financial Services and Markets Act 2000 (FSMA 2000) created a comprehensive scheme to regulate a variety of transactions. However, problems might still arise over whether or not an instrument is of a regulated kind (e.g. “futures” and commercial forward delivery contracts—see Chapter 3 below). In addition, characterisation is still important in order to determine which kinds of regulated investment are instruments under the FSMA 2000. Different rules (e.g. listing and disclosure rules regarding “securities”) could be applied to different instruments, so derivative instruments must still be assigned to their proper categories under the umbrella of the FSMA 2000.

In contrast, US law is more complicated. In the US, the securities regulation is based mainly on the Securities Act of 1933<sup>201</sup> and the Securities Exchange Act of 1934<sup>202</sup>, governed by the Securities and Exchange Commission (SEC). Commodity regulation is based on the Commodity Exchange Act (CEA)<sup>203</sup>,

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<sup>198</sup> See Financial Services and Markets Act 2000, section 26.

<sup>199</sup> For example, see *CR Sugar Trading Ltd v China National Sugar and Alcohol Group Corp* [2003] 1 Lloyd’s Rep 279 (about options on futures); *Procter & Gamble Co v Bankers Trust Co*, 925 F Supp 1270 (1996)(about securities).

<sup>200</sup> See generally, Berg, “Recharacterisation” (2001) 16(8) JIBFL 346; Benjamin, “Recharacterisation Risk and Conflict of Laws” (1997) 12(11) JIBFL 513.

<sup>201</sup> 15 USCA 77a *et seq.*

<sup>202</sup> 15 USCA 78a *et seq.*

<sup>203</sup> 7 USCA 1 *et seq.*

governed by the Commodity Futures Trading Commission (CFTC). US banks are regulated both under both federal and state laws by both federal and state banking regulators (the former includes the Board of Governors of the Federal Reserve System, the Office of Comptroller of Currency, and the Federal Deposit Insurance Corporation). Insurance business, in contrast, is regulated under state law.

For practitioners, answers to the question of characterisation or recharacterisation naturally start from the definition of relevant concepts. However, a deeper analysis would lead to an examination of the underlying rationale behind any private law or regulated rules of the relevant types of contracts. In other words, why are there certain special rules in insurance contract law? Why is gambling normally treated so negatively (or, as under the Gambling Act 2005, regulated)? Why does there exist a disclosure rule and an insider rule regarding securities trading? And why is exchange trading regulated? Derivative instruments might not look like insurance in most cases (see 2.5 below) or securities (apart from certain hybrid instruments). However, if derivative instruments raise similar problems to gambling, securities or insurance, they raise the question of whether we should apply the special rules, either in private law or in regulations, in each area to derivative instruments. This is the main theme of the present thesis.

This thesis will not develop a full and general theory of risk trading which requires the formation of a coherent view of laws regarding investment, insurance, futures, and gambling.<sup>204</sup> The purpose of this thesis is not to provide a basis on which to generalise laws regarding all sorts of investments (including securities, futures, insurance or others) and gambling. But instead, this thesis will examine certain arguments that test the boundaries between derivative instruments and related concepts.

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<sup>204</sup> See Hazen, "Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance" (2005) 24 Ann Rev Banking & Fin L 375; Hurt, "Regulating Public Morals and Private Markets: Online Securities Trading, Internet Gambling, and the Speculation Paradox" (2006) 86 BU L Rev 371; Pickens, "Of Bookies and Brokers: Are Sports Futures Gambling or Investing, and Does It Even Matter?" (2006) 14 Geo Mason L Rev 227.



We will approach from several dimensions. First, are future delivery contracts (traded on or off exchanges) true sales or notional sales? This relates to the boundary of “futures” regulation and the reasons why we regulate exchange-traded and OTC forward contracts, and forms the main theme in Chapter 3. Secondly, are cash-settled derivative instruments any different from gambling and should they be regulated in the same way as gambling? This issue will be discussed in Chapter 4. Thirdly, are derivative instruments insurance? Insurance law is rather special as it has both private law (i.e. insurance contract law) and regulatory implications (i.e. regulation of insurance business). Later in this chapter, we will discuss issues relating to the definition of insurance and insurance business. The private law aspect of insurance law would be incorporated into Chapters 4 and 5 when we discuss issues regarding gambling and information. Fourthly, derivative instruments undoubtedly have a close connection with other financial instruments. We will briefly examine whether derivative instruments can be seen as securities, and will also discuss certain issues relating to securities law (about disclosure) and insurance law (the duty of utmost good faith) in Chapter 5.

Before we move on, we should note that, apart from the themes introduced below, derivatives may cause further problems in corporate or securities law (e.g. disclosing ownership of shares, voting, and equity derivatives<sup>205</sup>), insolvency law (e.g. whether a party can claim set-off for obligations arising from derivative transactions<sup>206</sup>), banking law (e.g. how to evaluate derivative transactions for capital adequacy purposes<sup>207</sup>), tax law,<sup>208</sup> or in any branch of law where derivative transactions might create confusion or ambiguity.

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<sup>205</sup> For example, *E.ON AG v Acciona, SA*, 2006 US Dist LEXIS 84179; *Ithaca (Custodians) Ltd v Perry Corp* [2003] 2 NZLR 216. See also Hu, “The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership” (2006) 79 S Cal L Rev 811; Curran & Turitto, “FIAT/IFIL: The Securities Law Implications for Equity Derivative” (2006) 21(7) JIBFL 2297.

<sup>206</sup> For example, *Wallace v Merrill Lynch Capital Services, Inc*, 819 NYS 2d 214 (2006); *Finance One Public Company Ltd v Lehman Brothers Special Financing, Inc*, 414 F 3d 325 (2005).

<sup>207</sup> See Matthews, “Capital Adequacy, Netting, and Derivatives” (1995) 2 Stan JL Bus & Fin 167; Matthew Elderfield, “OTC Directives and the EC Capital Adequacy Directive” in Bettelheim et al. (ed.), *Swaps and Off-exchange Derivatives Trading: Law and Regulation* (FT Law & Tax, 1996); Das, *supra* note 114, at 755 *et seq*.

## 2.4 Financing and Capital Market

### Instruments

Categorising derivatives as financing agreements or capital market instruments might cause problems in certain regards. On the one hand, institutions may be under certain restrictions related to financing; but on the other, the possibility of a derivative being defined as a “security” might cause legal problems for market participants in the face of the registration/authorisation requirements and disclosure rules.<sup>209</sup>

Derivatives are generally seen as hedging or speculative instruments rather than fund-raising tools. The futures market provides a sharp contrast with the securities market. As an American judge has observed, “[s]ecurities usually arise out of capital formation and aggregation (entrusting funds to an entrepreneur), while futures are means of hedging, speculation, and price revelation without transfer of capital”.<sup>210</sup>

In contrast, the status of certain OTC transactions is less clear. First, a derivative transaction might actually look like a loan between parties if we apply a variation to the conventional structure: for example, a variation on a basic interest rate swap (see 2.2.2.3 above) requiring an upfront payment by the fixed rate payer might make an interest rate swap more like a loan. The best examples are the interest rate swaps with upfront payments that have been seen in certain local authority cases (see 2.3.1 above).

Secondly, a special argument that has been deployed in the US is whether a derivative transaction comes within the definition of “security” in the securities regulation, such that swaps might be considered regulated “securities”.<sup>211</sup> The application of US securities regulation is not merely a matter of registration with

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<sup>208</sup> For example, *see HSBC Life (UK) Ltd v Stubbs* [2002] STC (SCD) 9; *Inland Revenue Commissioners v Scottish Provident Institution* [2003] STC 1035; and Finance Act 2005, section 83 and paragraph 1 of Schedule 26.

<sup>209</sup> We will briefly discuss securities disclosure rules in *infra* 5.2.

<sup>210</sup> *Chicago Mercantile Exchange v SEC*, 883 F 2d 537, at 543 (1989).

<sup>211</sup> *See* 15 USCA 77b(a)(1) & 77b-1; 15 USCA 78c(a)(10).<sub>2</sub>

the SEC and the validity of a transaction. It also includes the application of the anti-fraud provision, which might result in civil liability or criminal penalty.<sup>212</sup> In *Procter & Gamble Co v Bankers Trust Co*,<sup>213</sup> Procter & Gamble (P&G) lost a lot of money through two swaps with the Bankers Trust. P&G argued that the swaps in question were “security” in the form of “investment contracts”, “notes”, “evidence of indebtedness”, “options on securities”, and “instruments commonly known as securities” in US securities regulation. The court rejected these arguments. It is outside the scope of this thesis to reproduce the lengthy development of US securities laws. However, crucial factors provided by the *P&G* judgment included the fact that the two swaps provided no pool of fund, no exchange principal, and no exercise of a right (like an option). Thus, the swaps in the *P&G* case were not securities under US law. The judgment was not favourable to P&G, but the case was eventually settled.<sup>214</sup>

In *Caiola v Citibank*,<sup>215</sup> the US court faced a further issue of whether synthetic options<sup>216</sup> and equity swaps were “security”. The *Caiola* case was concerned with Citibank’s refusal to continue conducting a more complicated trading strategy (more favourable to Caiola) as had been agreed upon and performed earlier. Caiola brought claims based on the anti-fraud provision of the Securities Exchange Act of 1934 and misrepresentation. The District Court declined to apply the securities regulation to these options and equity swaps. Upon appeal, the Second Circuit Court held that cash-settled options that referred to stock prices were within the meaning of “security”.<sup>217</sup> As to the equity swap, the Commodity Futures Modernization Act of 2000 (CFMA) actually excludes swap agreements from the definition of “security”, but the anti-fraud provision remains applicable to swap agreements based on securities.<sup>218</sup> Transactions between

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<sup>212</sup> See 15 USCA 78j.

<sup>213</sup> 925 F Supp 1270 (1996).

<sup>214</sup> See Kokkoris, “Liability of Swaps Dealers against Users” 2006 17(2) ICCLR 63, at 70.

<sup>215</sup> 295 F 3d 312 (2002).

<sup>216</sup> In this judgment, the synthetic options were options that were settled in cash (by referring to the value of the underlying stock), in contrast to a conventional stock option that required the writer of an option to deliver stocks once the option was exercised.

<sup>217</sup> 295 F 3d 312, at 327 (2002).

<sup>218</sup> See sections 302 & 303 of the CFMA, Public Law 106-554. See also 15 USCA 78c-1; 5 USCA 77q(a); Gramm-Leach-Bliley Act of 1999, section 206, Public Law 106-102.

parties ran smoothly before the introduction of the CFMA; thus Caiola had to provide further arguments to convince the court to apply the CFMA retrospectively (*cf. Procter & Gamble*<sup>219</sup>). However, the US court did recognise that the anti-fraud provision would have been applicable had the transactions occurred after the CFMA.<sup>220</sup> In the end, Caiola won the appeal and the whole case was remanded to the district court. From the *P&G* and *Caiola* case, it can be seen how an OTC contract might lead to the danger of being characterised as a regulated “security” in the US.

So far, no English case on the matter of security and interest rate swaps (or other OTC transactions) has arisen. Nevertheless, it may be argued that an English court would agree with the judgment of *Procter & Gamble* because an interest rate swap is not a share, a bond, a government bond, a typical instrument creating or acknowledging indebtedness, an instrument giving entitlements to investment or certificates representing certain securities.<sup>221</sup> The synthetic options in *Caiola* might be seen as options to acquire or dispose of a security or contractually based investment.<sup>222</sup> However, the bottom line is that cash-settled synthetic options and equity swaps could be defined as contracts for differences, such that the FSMA 2000 is applicable irrespective of whether or not they are securities.<sup>223</sup>

Thirdly, a hybrid instrument that has certain derivative features embedded into a traditional investment vehicle (see 2.2.2.4 above) might come within the definition of “security” in both the UK and US. For example, a CAT bond (see 2.2.2.4 above) is still a bond except that its payoff is conditional upon the occurrence or non-occurrence of a future event. In *Nikko Asset Management Co v UBS AG*,<sup>224</sup> Nikko Asset Management argued that the sale of two credit-linked notes<sup>225</sup> violated US securities laws; but it is a pity that the court dismissed the case for lack of jurisdiction without considering its merit. How

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<sup>219</sup> 925 F Supp 1270 (1996).

<sup>220</sup> 295 F 3d 312, at 327 (2002).

<sup>221</sup> See RAO 2001, articles 76–80.

<sup>222</sup> RAO 2001, article 83.

<sup>223</sup> RAO 2001, article 85.

<sup>224</sup> 303 F Supp 2d 456 (2004).

<sup>225</sup> A credit-linked note is a security (usually with fixed income) with an embedded credit derivative. Thus, the payoff of the note is linked to another person’s credit. See generally, Das, *supra* note 114, at 801 *et seq.*

to deal with hybrid instruments is a question for securities regulators to think about in the future. Whether the issuer of a hybrid instrument should comply with the same registration, authorisation, disclosure, and reporting rules as issuers of more conventional securities is an issue that this thesis would not pursue further.

Lastly, although the name of a product might include the word “security”, this does not mean that it should be treated like a conventional security (e.g. shares or bonds). For example, in *Morgan Stanley UK Group v Puglisi Cosentino*,<sup>226</sup> the product was called a “principal exchange rate linked security” but it was held to be a contract for differences under UK law and thus the rules of the Security Association would apply (see also 2.3.3 above).

In sum, classifying derivatives as financing instruments could have serious legal implications if there are any special rules restraining entry into financing agreements. A variation on the standard structure of a swap might actually look like a loan. In contrast, an OTC derivative instrument might not be defined as a typical security in the market, but certain hybrid instruments might raise the possibilities of applying rules about securities.

## 2.5 Insurance

Another question that might have serious legal implications is whether derivative instruments, if used for hedging purposes, are any different from insurance. Both the regulatory and contract law aspects of insurance law should be taken into account with respect to derivative transactions.

On the regulatory side, if a contract is an insurance contract, a person selling the contract to customers will be regulated as an insurance company (“insurer”).<sup>227</sup> An institution may be subject to penalties if it conducts insurance business<sup>228</sup>

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<sup>226</sup> [1998] CLC 481.

<sup>227</sup> In the FSA Handbook, the term “insurer” is defined as “a firm with permission to effect or carry out contracts of insurance” (other than a UK insurance special purpose vehicle). FSA Handbook, Glossary.

<sup>228</sup> In the FSA Handbook, “insurance business” is defined as “the business of effecting or carrying out contracts of insurance”. FSA Handbook, Glossary

without obtaining required licence from the local regulator.<sup>229</sup> An insurance policy issued by an unauthorised insurer is unenforceable in the UK.<sup>230</sup> Moreover, an institution should comply with insurance regulations if it is conducting insurance business. Financial regulations usually impose different prudential requirements on different types of financial institutions.<sup>231</sup> A non-insurance company might incur significant costs in order to comply with the prudential requirements for insurance companies. However, in the UK, if an authorised person carries on a regulated activity otherwise than in accordance with the permission granted, the person is said to be taken to have contravened a requirement imposed by the FSA. However, such contravention does not make that person guilty of an offence or render a transaction void or unenforceable.<sup>232</sup> Thus, the legal consequences of selling illegal insurance would vary depending on whether the person is already an authorised person.

On the private law side, being an insurance contract might invite the application of the special rules in the law of insurance contract, such as utmost good faith, duty to disclose, etc. These rules not only define the rights and obligations of the parties to an insurance policy. They may also influence the validity of a transaction, e.g. the violation of the duty of utmost good faith (see 5.3.1 below).

Three major issues flow from characterising a derivative instrument as insurance: first, whether a seller of derivative instruments should be regulated as an insurer; secondly, whether a derivative instrument should be limited to the function of indemnity; and thirdly, whether a derivative instrument should be seen as another type of contract *uberrimae fidei*. All three issues are linked to the key question regarding the meaning of “insurance”. The first and part of the second issue will be addressed in this chapter. The third question will be dealt with in section 5.3. Issues related to indemnity will also be discussed in section 4.4.2 below.

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<sup>229</sup> See FSMA 2000, section 23.

<sup>230</sup> See FSMA 2000, section 26.

<sup>231</sup> For example, the FSA Handbook provides different prudential source books for banks, insurance business, building societies, and friendly societies. This reflects the nature of business of different types of financial institutions.

<sup>232</sup> See FSMA 2000, section 20.

## 2.5.1 Definition of Insurance

A natural starting point is the definition of “insurance” in law. Although often used in statutes,<sup>233</sup> in England, the definition of insurance is largely decided by case law.<sup>234</sup> In *Prudential Insurance Company v Commissioners of Inland Revenue*<sup>235</sup>, Channell J described three basic elements to a contract of insurance: (1) the assured will become entitled to something on the occurrence of some event; (2) the event must be one which involves some element of uncertainty; and (3) the assured must have an insurable interest in the subject matter of the contract.<sup>236237</sup>

In the FSA Handbook, the Financial Services Authority (FSA) summarises that the *Prudential Insurance* case

“treats as insurance any enforceable contract under which a ‘provider’ undertakes: (1) in consideration of one or more payments; (2) to pay money or provide a corresponding benefit (including in some cases services to be paid for by the provider) to a ‘recipient’; (3) in response to a defined event the occurrence of which is uncertain (either as to when it will occur or as to whether it will occur at all) and adverse to the interests of the recipient.”<sup>238</sup>

The application of the above definition to derivatives varies from product to product. There are certain points that we might develop from the definition of insurance.

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<sup>233</sup> For example, Appropriation Act 2004, Finance Act 2004, Proceeds of Crime Act 2002, Enterprise Act 2002, Capital Allowance Act 2001, Finance Services and Markets Act 2000, Welfare Reform and Pension Act 1999, etc.

<sup>234</sup> Although imperfect, there is a statutory definition with regard to marine insurance. Section 1 of the Marine Insurance Act 1906 provides that “[a] contract of marine insurance is a contract whereby the insurer undertakes to indemnify the assured, in manner and to the extent thereby agreed, against marine losses, that is to say, the losses incident to marine adventure”. This definition does not provide us with a full comprehension of insurance.

<sup>235</sup> [1904] 2 KB 658, at 663-665.

<sup>236</sup> See also *Medical Defence Union Ltd v Department of Trade* [1980] Ch 82, at 89-90.

<sup>237</sup> In the US, the definition of insurance varies from state to state. For New York law, see New York CLS Insurance § 1101. For Illinois law, see generally Illinois Jurisprudence, Insurance § 1:1.

<sup>238</sup> FSA Handbook, PERG 6.3.4.

First, some types of derivatives (such as commodity forward contracts and interest rate swaps) lack the payment of a premium. Thus, one is not, at least on the face of it, paying a sum to buy protection from the counterparty through a forward contract or an interest rate swap, though the purpose of such a transaction might be to hedge. In contrast, contracts like credit default swaps (see 2.2.2.3 above), under which a sum of money is paid in return for a payment obligation triggered by a certain credit event or movement in the market, might not greatly differ.<sup>239</sup> Therefore, if we insist on the “premium” element, many derivative instruments will be excluded from the definition of “insurance”.

Secondly, the meaning of an adverse event is open to argument. The focus naturally falls on an occurrence or non-occurrence of something: thus, the default (or insolvency) of a person might be seen as an event, as might a natural disaster. However, it is arguable whether market fluctuations could be counted as an “event”. For some derivative instruments (e.g. interest rate swaps) it may be argued that final payment is decided upon the netting of two payments from two parties (e.g. the floating rate payment and the fixed rate payment) rather than upon market movements.<sup>240</sup> Thus, the requirement of an adverse event might be evaded. On the other hand, the FSA also recognises that a contract is less likely to be insurance if the underlying risk carries the possibility of either profit or loss.<sup>241</sup> If we pursue this line of analysis, market fluctuations might not be seen as an insurable event as the assumption of risk could result in either profit or loss, depending on market movements.

Thirdly, the insurable interest test is another key element. Further discussion on the insurable interest test and derivative instruments will take place below in section 4.4.2. At this stage, it should be noted that insurable interest in a life policy is strongly linked to the moral hazards that might not be visible in most derivative transactions. Insurable interest in property insurance is linked to wagering and the nature of indemnity. In addition, as will be argued in Chapter 4, it is not impossible for a party to a derivative instrument to have an interest in

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<sup>239</sup> See generally, Hudson, *supra* note 24, at 6-09.

<sup>240</sup> *Id.*

<sup>241</sup> FSA Handbook, PERG 6.6.8(2).



the subject matter of the transaction that may be defined as insurable interest. In this instance, still further arguments would be needed to distinguish derivative transaction from insurance.

Fourthly, the Financial Services and Markets Act (Regulated Activities) Order 2001 (RAO 2001) provides a list of contracts of general insurance to which reference may be made particularly in relation to “credit”, “suretyship” and “miscellaneous financial loss”. First, the class of “credit” is defined as “[c]ontracts of insurance against risks of loss to the persons insured arising from the insolvency of debtors of theirs or from the failure (otherwise than through insolvency) of debtors of theirs to pay their debts when due.”<sup>242</sup> Secondly, the class of “suretyship” is defined as “[c]ontracts of insurance against the risks of loss to the persons insured arising from their having to perform contracts of guarantee entered into by them.”<sup>243</sup> Fidelity bonds or performance bonds might also be defined as insurance under certain conditions.<sup>244</sup> Thirdly, the term “miscellaneous financial loss” is quite broad, including but not limited to risk of loss to the persons insured attributable to interruptions of the carrying on of business or to incurring unforeseen expenses.<sup>245</sup>

One common denominator in the definitions in the RAO 2001 is the “risk of loss”. The fact that the payment obligation of a derivative instrument need not be triggered by “loss” marks an important difference between an insurance contract and a derivative transaction.<sup>246</sup> Sometimes market participants do not even suffer any “loss” from a legal point of view, yet they may still demand payment. Thus, we might argue that derivative instruments are not used to indemnify a party’s actual loss.<sup>247</sup> Therefore, derivative instruments are not akin to insurance if they are not used to indemnify the real losses of a party. As we will also see later, this seems to be the prevailing opinion in the UK and US.

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<sup>242</sup> SI 2001/554, Schedule 1, paragraphs 14. *See infra* Appendix 1 for a full reprint of these paragraphs.

<sup>243</sup> RAO 2001, Schedule 1, paragraph 15.

<sup>244</sup> *See* RAO 2001, Schedule 1, paragraph 15(2).

<sup>245</sup> *See* RAO 2001, Schedule 1, paragraph 16.

<sup>246</sup> *See* Edwards, “The Law of Credit Derivatives” (2004) JBL 617, at 647-649.

<sup>247</sup> We will have a more thorough analysis on loss and indemnity in *infra* 4.4.2.2.

However, it is easy to ignore the fact that it is the law that reduces property insurance to those contracts indemnifying the real losses of an assured. Without the insurable interest test and the restriction of indemnity, the insurance market might not be as it is today. Thus, a deeper question flowing from arguments about “loss” is whether we should limit derivative instruments to those that indemnify losses. In addition, it is easy to ignore the fact that life assurance is still a contract of insurance, but a contract of contingency.<sup>248</sup> Thus, arguments about loss and indemnity contrast property insurance and derivatives, but they do not provide a complete answer if we add life assurance to the mix. We will discuss this point further in section 4.4.2.

From a practitioner’s point of view, it is probably enough to argue that the definition of insurance and the nature of indemnity might be enough to distinguish property insurance from derivative instruments. However, whether the latter are defined as insurance or not, it is still an open question whether a seller of derivative instruments should be regulated and whether derivative instruments should be limited to indemnity or could be seen as another form of contract *uberrimae fidei*.<sup>249</sup>

In general, the FSA takes the definition of insurance as in common law.<sup>250</sup> If a contract falls outside the description in common law, it is unlikely to be regarded as “insurance” for regulatory purposes.<sup>251</sup> However, the FSA also extends the meaning of “contract of insurance” to fidelity bonds and similar contracts of guarantee.<sup>252</sup> Thus, it is not appropriate to assume that the FSA would only regulate those contracts that are commonly regarded as “insurance”. On the

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<sup>248</sup> See *supra* note 45.

<sup>249</sup> See *infra* 5.3 for further discussion on this issue.

<sup>250</sup> FSA Handbook, PERG 6.3.4.

<sup>251</sup> FSA Handbook, PERG 6.5.1.

<sup>252</sup> FSA Handbook, PERG 6.3.2. One question which might arise is whether credit derivatives are “similar contracts of guarantee”. It is not quite clear whether the term means contracts of guarantee within the legal definition which have the same effect as the instruments listed in the same paragraph (such as a performance bond) or whether it means contracts that have the same effect as a guarantee even if they have different legal characteristics. Thus, there is a certain degree of legal uncertainties. See James, *The Law of Derivatives*, at 35 (LLP, 1999). Whatever the term “similar contracts of guarantee” means, the RAO 2001 makes it clear that these contracts might become “suretyship” only when they are not effected incidentally to some other business carried out by the person effecting them, and when they are effected in return for the payment of one or more premiums. See RAO 2001, Schedule 1, paragraph 15(2).

other hand, if it is not clear whether a contract could be defined as insurance in common law, “the FSA will interpret and apply the common law in the context of and in a way that is consistent with the purpose of the [FSMA 2000] as expressed in the FSA’s statutory objectives.”<sup>253</sup> The FSA will decide on the facts and merits of each case and put more weight on the substance rather than the form of a contract.<sup>254</sup>

In the following sections, we will continue to introduce certain existing arguments about three types of derivative instruments that are similar to insurance policies in certain regards: weather derivatives, credit derivatives, and longevity products. We will then return to the regulation of insurance business in the end.

## 2.5.2 Weather Derivatives

In general, weather derivatives are derivative instruments in which the payoff is based on a climatic variable, such as average temperature or snowfall during a specified period of time (see 2.2.2.3 above). Weather derivatives provide protection against weather or climatic conditions, which makes them in a way similar to insurance policies against weather or natural disasters.

The Insurance Department of New York has determined that weather derivatives do not constitute insurance contracts since the terms of the instrument do not provide that, in addition to or as part of a triggering event, payment to the purchaser is dependent on that party suffering a loss.<sup>255</sup> Thus, the insurance regulator in New York does not see weather derivatives as part of the insurance business. But whether the seller should be regulated as other types of institutions (e.g. a bank) is not within New York insurance regulator’s jurisdiction.

In contrast, in England, the Financial Services Authority (FSA) takes another route by defining a weather derivative as a “contract for differences” rather than

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<sup>253</sup> FSA Handbook, PERG 6.5.3.

<sup>254</sup> FSA Handbook, PERG 6.4.3 and 6.5.4.

<sup>255</sup> Insurance Department, Opinions of General Counsel, Opinion Number 00—02—05. See <<http://www.ins.state.ny.us/ogco2000/rg000205.htm>> (visited on 7 December 2006).

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insurance.<sup>256</sup> Thus, we may assume that the FSA also does not see weather derivatives as “insurance” and that a seller of weather derivatives would not be regulated as an insurer.

The approach taken by the FSA is sensible and it also reflects the flexibility of the UK financial regulation. However, in a jurisdiction where there is no such comprehensive regulatory scheme as the Financial Services and Markets Act 2000 (FSMA 2000), how to distinguish weather derivatives and insurance may still be a real legal question. The New York insurance regulator’s decision to distinguish weather derivatives from insurance based on the fact that payment of a weather derivative does not depend on the suffering of a loss is reasonable. However, there is still a possibility that an end-user of a weather derivative instrument does suffer some losses or the intention of entering into a weather derivative transaction is indeed to indemnify the loss suffered. It then relates to the question: why do we limit insurance to indemnifying a real loss? We will further consider this issue in Chapter 4 (see 4.4.2).

### 2.5.3 Credit Default Swap

What raises most discussion regarding insurance and derivative instruments is the credit derivative. As there are several types of credit derivatives, we will focus on credit default swaps (CDS—see 2.2.2.3) in this section.

So far the English court has not issued any judgment on credit default swaps and insurance. An opinion was given, by Robin Potts QC in 1997 to the ISDA, that credit derivatives were not structured to provide an indemnity for loss and thus they did not fall within the then Insurance Companies Act 1982.<sup>257</sup> However, the FSA seems to have reservations regarding this opinion. The FSA notes that a credit event may be defined in a way that the event is impossible to occur without a party suffering a loss and that it is not clear that

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<sup>256</sup> See FSA Handbook, Glossary.

<sup>257</sup> See Henderson, *supra* note 43, at 12.11; FSA Discussion Paper, Cross-sector Risk Transfers, at Annex B (May 2002); downloadable from <<http://www.fsa.gov.uk/pubs/discussion/dp11.pdf>> (visited on 11 February 2008).

only contracts that respond to actual loss can be contracts of insurance.<sup>258</sup> The FSA also notes that the boundary between insurance and credit derivatives is becoming unclear as insurance companies effectively underwrite credit insurance on the same terms as a credit default swap.<sup>259</sup>

On the other side of the Atlantic, a US judge has observed that

“[c]redit default swaps are a method by which one party (the protection buyer) transfers risk to another party (the protection seller). . . . . CDS agreements are thus significantly different from insurance contracts. As amicus [provided by the International Swaps and Derivatives Association] correctly points out, they ‘do not, and are not meant to, indemnify the buyer of protection against loss. Rather, CDS contracts allow parties to ‘hedge’ risk by buying and selling risks at different prices and with varying degrees of correlation.’”<sup>260</sup>.

A definition of “credit default swap” was also added to the New York insurance law in 2004. To quote in full:

“‘Credit default swap’ means an agreement referencing the credit derivative definitions published from time to time by the International Swap and Derivatives Association, Inc. or otherwise acceptable to the superintendent, pursuant to which a party agrees to compensate another party in the event of a payment default by, insolvency of, or other adverse credit event in respect of, an issuer of a specified security or other obligation; *provided that such agreement does not constitute an insurance contract and the making of such credit default swap does not constitute the doing of an insurance business.*”<sup>261</sup> (Emphasis added)

Therefore, the prevailing view in New York seems to be that a CDS is, in principle, not an insurance contract because it is not used to indemnify a party against actual losses. Nevertheless, New York law does not rule out the possibility that a CDS might still be regulated as an insurance contract provided

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<sup>258</sup> FSA Discussion Paper, *id.*

<sup>259</sup> *See* FSA Discussion Paper, *id.*, at 3.116.

<sup>260</sup> *Aon Financial Products, Inc v Société Générale*, 476 F 3d 90, at 96 (2007). *See supra* note 164 for more details of this case.

<sup>261</sup> NY CLS Insurance 6901(j-1).

that a CDS fits the definition of insurance. However, at least the New York law makes it clear that a CDS and an insurance contract are not synonymous.<sup>262</sup>

In a recent article, Schwartz, an American author, argues that a CDS is, in general, different from insurance. He argues from two levels: the contract level and the market level.<sup>263</sup> On the contract level, Schwartz analyzes the issue by comparing the parties who may enter into the contract; the property to which the contract may extend; the extent to which the purchaser may transfer the contract; the sort of event that warrants a claim under the contract; how the contract measures recovery; and how the parties settle their contracts.<sup>264</sup>

As to “who” may enter into the CDS market, Schwartz contends that currently only a limited class of “eligible” market participants (which only include institutional investors) may buy or sell CDS without being regulated by either the Securities Exchange Commission or the Commodity Futures Trading Commission so that a CDS contract is different from an insurance policy.<sup>265</sup> As for property, Schwartz argues that there is no insurable interest aspect for CDS instruments and no moral hazard issue in the CDS market.<sup>266</sup> Schwartz further contends that a CDS is far less concerned with the personal identity of a protection buyer (*cf.* an insured) and is more liquid if the buyer wishes to transfer his interests in a CDS instrument.<sup>267</sup> He also notes that there is no provable loss needed to trigger payment under a CDS and that the measure of recovery of a CDS does not depend on the real loss suffered.<sup>268</sup> In the end, Schwartz argues that the use of cross-payment netting and the possibility of physical settlement make a CDS different from the insurance model.<sup>269</sup> Therefore, Schwartz argues that a CDS is different from insurance on the contract level.

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<sup>262</sup> Schwartz, “Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation” (2007) 12 Fordham J Corp & Fin L 167, at 183.

<sup>263</sup> *Id.*, at 188.

<sup>264</sup> *Id.*, at 189 *et seq.*

<sup>265</sup> *Id.*, at 189.

<sup>266</sup> *Id.*, at 190-191.

<sup>267</sup> *Id.*, at 191-192.

<sup>268</sup> *Id.*, at 192-194.

<sup>269</sup> *Id.*, at 191-196.

On the market level, Schwartz distinguishes a CDS from insurance based on three factors: first, no risk class (but a credit spread) created in the CDS market; secondly, the existence of credit indices to allow for price discovery by both protection buyers and sellers; and thirdly, the limited class of market participants.<sup>270</sup> In conclusion, Schwartz argues that a CDS is better seen as a capital market instrument rather than insurance.

This thesis agrees with Schwartz's observations that a CDS is different from conventional insurance policies, and that there are certain fundamental differences between traditional insurance and CDS in the market. Currently, CDS are much less personalised than traditional insurance policies and more liquid in terms of trading. This provides a basis for seeing CDS as different from traditional insurance policies.

However, whether these differences are enough to justify CDS instruments from being treated like insurance in law is not fully answered in the article. First, Schwartz seems to accept certain doctrines in insurance law (such as indemnity or insurable interest) as they are. However, he does not elaborate on the reasons why there are special rules for insurance policies and whether CDS might share similar problems. In fact, as will be discussed in Chapter 5, CDS might also produce moral hazard issues, contrary to what Schwartz suggests.<sup>271</sup> Secondly, as far as Schwartz's arguments goes, the differences between CDS and insurance are not absolute. It is granted that CDS, in general, are more liquid, less personalised, and not necessarily about the real losses suffered by a protection buyer. Nevertheless, there are CDS transactions which are never transferred to a third party, more personalised or tailor-made and/or about compensating real losses incurred by a protection buyer. Thus, the question is whether it is enough to completely separate the class of transactions that we label as "credit default swap" from insurance based on these differences for most CDS transactions. Or, as the National Association of Insurance Commissioners in the US once suggested in a draft white paper, credit

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<sup>270</sup> *Id.*, at 196 *et seq.*

<sup>271</sup> *See id.*, at 191. *See infra* 5.3 for further discussion on the information issue.

protection sellers are involved in accepting risk transfers for a fee (which may be deemed as nothing more than an insurance premium) and the mere likelihood of some catastrophe caused by derivatives posing as insurance is a reason enough for an insurance regulator to step in.<sup>272</sup> Schwartz seems to adopt the former view.

In sum, this thesis agrees with most of Schwartz's arguments that there are differences between CDS and conventional insurance policies. However, this thesis reserves the opinion about the arguments that these differences are enough to distinguish CDS from insurance as a matter of law. To resolve whether a CDS should be considered insurance, we should also consider the underlying rationale behind insurance regulations and insurance contract law. This is how this thesis would approach issues relating to insurance and credit derivatives. Certain arguments relating to insurance regulation will be introduced later in this chapter (see 2.5.5 below). Issues relating to speculation and information will be considered in Chapters 4 and 5 respectively.

## 2.5.4 Longevity Products

So far we have assumed that derivative instruments have nothing to do with the life or death of human beings. In fact, new derivative instruments have developed to address the so-called "longevity risk" (or "mortality risk"), that is the gradual lengthening of human lives. The ever-increasing life expectancies might be the achievement of a well-developed modern society: however, it has certain monetary effects for some market participants. For example, pension funds have to pay more if, on average, pensioners live longer. In contrast, life insurers are at the more positive end because they might not have to pay (depending on the terms of a policy) until the assured's death. Based on the changes in life expectancy, a swap could be made between a pension fund and a life insurer.<sup>273</sup>

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<sup>272</sup> Schwartz, *supra* note 262, at 187.

<sup>273</sup> Das jokingly calls it a "death swap". See Das *supra* note 121, at 108–110. Derivative instruments based on longevity might also be structured as an option or a hybrid instrument.



It is still in the early stages of developing a matured market for longevity risk. After all, an immediate drop in life expectancy in the developing world is not expected unless there is a World War III or a deadly world-wide pandemic. However, the existence of the longevity market gives food for thought with regard to insurance and derivatives. A longevity instrument might not be seen as a life assurance policy as long as a derivative instrument is based on the longevity or mortality rates of human beings as a whole (in a specific country or area). Nevertheless, it is not just pure imagination to conjecture that two people might enter into a swap based on the life expectancy of a specific person (or a class of people). As the population in a society ages, there will be an increased burden on younger people to support the pension system and, at the very least, their own family members. There could be considerable monetary expenses, if we take into account the necessary costs of medical care for the elderly. Thus, it is not hard to imagine that one may use a derivative technique to reach the same financial goal that is intended by the buying of a life policy or annuity.

However, this possibility might also raise certain concerns about moral hazards. The more specific the person or group of persons, the more likely that that person or persons is exposed to potential danger. Arguments about “loss” would lose their charm if that concerned life policies. This scenario might be purely only imaginary: however, the purpose of this section is to demonstrate that derivative instruments might share some grounds with life insurance and that it is not impossible for the regulation of life assurance to provide a basis to regulate certain longevity products in the future.

### **2.5.5 Regulation of Insurance Business**

If the regulation of insurable business is our primary concern, we should ask ourselves why we regulate insurance business. Are insurers regulated only because they sell insurance policies? Are they regulated because they collect premiums from the general public and there is a genuine issue about protecting assureds from default by or the insolvency of an insurer? Or are they regulated because of the role they play in the financial market? This angle gives us

something to think about in addition to the definition of insurance and/or the range of insurance products that can be sold under current regulations. The regulatory objectives of the FSMA 2000<sup>274</sup> should be the guide when we consider whether a contract should be considered as insurance for regulatory purposes.<sup>275</sup>

With this view in mind, the initial question that should be asked is whether a seller of derivative instruments should be regulated, assuming that the seller carries on dealing in derivative instruments as business. Then we may consider what type of institution the seller should be compared to for the purpose of regulation. Perhaps they could be regulated as a bank, or an insurer, or perhaps it might be better to have a separate class of “derivative business”.

We will not elaborate this point any further. As was mentioned in Chapter 1, this thesis would not provide a full regulatory analysis of the derivatives market. However, if we accept the above argument, then banks or other regulated non-insurance financial institutions should not be treated as insurers,<sup>276</sup> unless we can identify the need for a separate set of regulations. Indeed, banks are major players in the derivatives market, though they may establish specialised subsidiaries to deal with derivatives business (see 4.4.3.3 below). However, according to a recent report, certain insurance companies also have a significant role in the credit derivatives market.<sup>277</sup> If a seller of derivative instruments is already a regulated insurer, there is no need to argue any further about the seller’s status as an insurer. If a seller is neither a bank nor an insurer, then it opens the door for further argument.

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<sup>274</sup> The regulatory objectives of the FSMA 2000 are maintaining market confidence, promoting public awareness, securing protection of consumers, and reducing financial crimes. See FSMA 2000, sections 3 to 6.

<sup>275</sup> See FSA Handbook, PERG 6.5.3.

<sup>276</sup> See also Financial Law Panel, Credit Derivatives: the Regulatory Treatment: A Guidance Notice (Financial Law Panel, 1997); Henderson, *supra* note 43, at 12.11.

<sup>277</sup> Fitch Ratings, CDx Survey—Market Volumes Continue Growing while New Concerns Emerging, downloadable from <<http://www.fitchratings.com/>> (visited on 10 August 2007). See also FSA Discussion Paper, Cross-sector Risk Transfers (May 2002); downloadable from <<http://www.fsa.gov.uk/pubs/discussion/dp11.pdf>> (visited on 11 February 2008).

Hudson contends that “the most effective argument against derivatives being construed as being insurance contracts is that there is simply no intention to provide straightforward insurance”.<sup>278</sup> Hudson further argues that

“[m]uch may depend on whether or not the parties’ underlying intention is speculation – which would not constitute insurance compensating any loss ... [M]uch will depend upon whether the courts take a literal interpretation of the existing law or whether the courts take a purposive interpretation of that law by reference to the parties’ underlying commercial objectives.”<sup>279</sup>

This thesis agrees in part. We agree that much depends on how the court looks at a specific transaction and whether the court takes a literal interpretation of relevant laws. In essence, it depends on whether the court is willing to restrict the application of insurance law to those instruments that we traditionally see as “insurance” (or within insurance business), and to leave those instruments that we generally label as derivatives outside the reach of insurance law.

However, the present thesis is not predisposed to use speculation as a concept to separate insurance and derivative instruments. Speculation was (and probably still is) a problem for insurance contracts. As will be discussed in Chapter 4, the insurable interest test and the requirements for indemnity are more or less intended to eliminate gaming or wagering through insurance policies (see 4.4.2 below). The extent to which speculation by way of derivative instruments should be allowed is still an open issue.

## 2.5.6 Summary

In short, the question whether a derivative can be regarded as an insurance contract creates a substantial risk for contractual parties. As the market develops and more complicated products are launched, the problem will persist and eventually it might be decided on a case-by-case or product-by-product basis. If used for hedging purposes, both traditional insurance policies and derivative instruments serve the purpose of managing risk exposure, but they use different

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<sup>278</sup> Hudson, *supra* note 24, at 6–12.

<sup>279</sup> *Id.*

techniques to reach their goals. The approach taken here regarding insurance is not merely to focus on the current definition of insurance but to explore further the reasons why insurance is special in law. This approach provides a better overview of the whole financial and risk management market. We may summarise the position taken in this thesis in the following points.

First, we recognise that most derivative instruments do not look resemble conventional insurance policies that indemnify the real losses suffered by an assured (*cf.* property insurance) or that compensate the assured for early death (*cf.* life insurance) or longer life (*cf.* annuity). However, there are also certain types of derivative instruments (particularly credit default swaps) that may look like insurance policies from certain perspectives.

Secondly, one common argument is that payments under derivative instruments do not normally depend on the occurrence or non-occurrence of “loss”. This thesis agrees that, if we accept the indemnity nature of property insurance, loss is a useful criterion for distinguishing insurance and derivative instruments—a criterion which is also accepted by New York insurance regulators and the Second Circuit court. However, we should be aware that it is less clearly understood why insurance is limited to indemnity and whether modern derivative instruments should be reduced to those indemnifying the economic loss of a market participant.

Thirdly, on the matter of insurance regulation, this thesis takes the position that it is better to rethink the reasons behind the regulation of insurance business. In short, the questions are: whether sellers of derivative instruments need to be regulated, and how to regulate them. This angle would provide a more complete analysis than merely emphasising the indemnity nature of property insurance and the definition of “insurance”. After all, insurers are not regulated merely because insurance is a contract of indemnity.

Lastly, by comparison with insurance business, the private law aspect of insurance law in relation to derivative instruments has been far less researched. Apparently, the easiest way to avoid the application of insurance contract law is

to argue that a derivative instrument cannot be defined as “insurance”. This is reflected along the line of arguments about indemnification of “loss” and derivatives, and also in the fact that both the regulatory and private law aspects of insurance law hinge upon the definition of “insurance”. Whether the definition of “insurance” should be identical for both insurance regulation and insurance contract law is a question that should be left to insurance lawyers. In fact, under the FSMA 2000 the notion of contract of insurance also includes certain instruments (e.g. performance bonds) that might not be seen as insurance if not conducted by an insurer.<sup>280</sup> However, this does not hide the fact that derivative transactions may involve a certain degree of speculation and asymmetric information. This thesis will further pursue these issues in Chapters 4 and 5.

## 2.6 Conclusion

In the discussion above, we first described the meaning of risk and various types of risks: including price risk, credit risk, hazards, liquidity risk, and operational risk, etc. Over the years, several contractually based instruments, such as security interests, guarantees, and insurance, etc., have been created to combat risks. However, such traditional hedging methods no longer satisfy the market. As the use of derivatives grows, “risks” are being identified and traded specifically in the over-the-counter market or in the exchange market. From the early development of grain futures to the innovation of swap agreements since the 1970s, derivatives can provide more protection than other existing legal instruments. As financial innovation has speeded up in recent decades, derivatives transactions have become more and more complicated. To some extent, risks are treated like goods, sold and purchased by market participants. In short, risk has become the subject matter of trading.

However, the development of derivatives is still based on existing legal concepts. Derivative instruments might be classified within the confines of a single existing area of law so that regulatory rules or certain private law doctrines might be applicable to derivative instruments. This creates a substantial legal risk for

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<sup>280</sup> See RAO 2001, article 3.

market participants using derivative instruments. In this chapter, we introduced the local authority cases and discussed the complexity of legal issues when a derivative instrument is rendered void. We also discuss whether derivative instruments might be seen as a financing instrument and whether they are insurance. It was argued that, in principle, derivative instruments are not security, financing agreements or property insurance policies. However, variations to more typical types of derivatives might increase the likelihood that an instrument be deemed a financial tool or insurance policy.

In the next two chapters, we will take another look at derivative instruments from the perspectives of commercial sale of goods, gambling and insurance contract law. In Chapter 3, we will examine the transition from commercial sales to notional trading in an exchange market, in order to explore the potential risk involved in classifying derivatives as regulated “futures” contracts. Chapter 4 will move on to the speculative end of business and examine contracts settled by cash, using the development of gambling and insurance laws as a mirror to reflect the current development of derivatives trading.

# Chapter 3 From Physical to Notional – Commodity Trading

## 3.1 Introduction

This chapter will focus on the contractual arrangements and market structure that have transformed a physical trading market into a notional market.<sup>1</sup> Hedging market risks by fixing future delivery prices is a strategy used by merchants all over the world from time immemorial.<sup>2</sup> However, not until the middle of the 19th century was a modern organised exchange established, forming the foundation of contemporary futures transactions. Even now, some futures contracts may still allow physical delivery, though most market participants are uninterested in the physical goods themselves.<sup>3</sup> Commodities futures provide a link between real sales and notional sales.

It is generally accepted that organised exchanges are regulated by financial regulation (see 3.1.2 below). Nevertheless, it is less clear whether an off-exchange commodity contract comes within the regulatory definition of “futures”. This creates legal risk for commodity traders who buy and sell

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<sup>1</sup> In this chapter, “physical trading” or “real sale” refers to commodity contracts of sale with the intention to make delivery. In contrast, “notional trading” or “notional sale” refers to contracts disguised in the form of sale of goods but not intended for delivery.

<sup>2</sup> Similar strategies were used in ancient Greece and for tulip sales in Holland in the Middle Ages. See Hudson, *The Law on Financial Derivatives*, at 2-01 (4th ed., Sweet & Maxwell, 2006). It is also reported that similar trading took place in around 2000 BC in the Bahrein Islands and in China. See Markham, *The History of Commodity Futures Trading and Its Regulation*, at 3 (Praeger, 1987); Hou, “Derivatives and Dialectics: The Evolution of Chinese Futures Market” (1997) 72 NYU L Rev 175, at 175-176. See also Romano, “A Thumbnail Sketch of Derivative Securities and Their Regulation” (1996) 55 Md L Rev 1, at 8. Japan’s rice exchange in the 17th century has been described as the first organised exchange in the world. See Turner & Suzuki, “Japan Plans to Resurrect Rice Futures Market” *Financial Times* (9 December 2005).

<sup>3</sup> In 1971, it was reported that approximately 99% of wheat futures traded in the CBOT were liquidated before delivery. *Cargill, Inc v Hardin*, 452 F 2d 1154, at 1157 (1971).

commodities for future delivery. As will be argued below, the contractual structure of exchange trading is the key to understanding the purpose of futures regulation and to avoid legal risk arising from certain off-exchange regulation. The following sections will first introduce the legal risk associated with notional sales and the scope of current UK and US “futures” regulations. The contractual structure of exchange trading will then be deconstructed in order to see why “futures” are regulated. Then, we will examine certain types of contracts that raise some issues relating to regulated futures contract. Finally, we will try to answer one question: what constitutes a “futures” contract as a matter of law? For simplicity of discussion, “cash market” and “spot market” mean a market where merchants make real sales, as opposed to the futures market.

### **3.1.1 True Sales or Notional Sales: from *CR Sugar***

Although derivative instruments seem to be a far cry from the cash market, in certain situations whether or not a contract is a true sale of goods does have legal implications. First, at the private law level, we have to consider the application of sale of goods law. For example, one particular concern in the US is whether the Statute of Frauds requirement in the Uniform Commercial Code (UCC) for “[a] contract for the sale of goods for the price of \$5,000 or more” is applicable.<sup>4</sup> Since derivatives trading can be carried out over the phone, the lack of proper documentation at the time of trading might endanger the enforceability of a transaction.<sup>5</sup> One might further inquire as to the meaning of “goods” in sale of goods laws.<sup>6</sup> For example, certain deliverable credit default swaps might fall under sale of goods laws if the concept of “goods” were to include bonds, as might be the case in some continental European legal systems.

Secondly, whether a contract is intended as a true physical sale or a notional sale settled by cash raises more serious regulatory concerns. The risk is best

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<sup>4</sup> UCC Article 2-201. See also Bhala, “A Pragmatic Strategy for the Scope of Sales Law, the Statute of Frauds, and the Global Currency Bazaar” (1994) 72 Denv UL Rev 1.

<sup>5</sup> See Hudson, *supra* note 2, at 3–17 *et seq.* (absence of documentation). If trading is simply done over the telephone, it could also raise questions as to whether the terms of the standard form of the ISDA agreement could be incorporated into the contract. See *Credit Suisse Financial Products v Société Générale d'Enterprises* [1997] CLC 168.

<sup>6</sup> See section 61(1) of Sale of Goods Act 1979. For the US law, see UCC Article 2-105(1).



illustrated by an English case. In *CR Sugar Trading Ltd v China National Sugar and Alcohol Group Corp*,<sup>7</sup> the claimant (CR) was a sugar trader based in the UK. CR purchased a series of put options written by CSW, a Chinese company, so that CR could sell quantities of raw sugar to CSW upon exercise of the options. As Steel J found out, the purpose of the options trading was to generate profit for both CR and CSW, and not to deliver sugar.<sup>8</sup> CSW was able to earn premiums on the options. In contrast, the existence of the options allowed CR's New York affiliate to open hedging positions on the New York futures market.<sup>9</sup> Most of the options were not exercised or were simply rolled over for a new period. However, on one occasion when CR did exercise two of these put options, CSW refused to draw a letter of credit and purchase the sugar. CR duly brought a claim to arbitration against CSW.

One of CSW's lines of defence was that CR was an unauthorized investment business in violation of the Financial Services Act 1986 (FSA 1986), with the result that the put options in dispute were unenforceable. Both the arbitral tribunal and the English court held that, since both CR and CSW did not really consume or put the sugar into service, the options were not made for commercial purposes but for investment purposes. In short, CR could not enforce the put options because the options were not considered as true sales but as investments. To see why CR lost its case, one must bear in mind current UK law on the meaning of "futures"<sup>10</sup>. We will juxtapose the US law for purposes of comparison.

### 3.1.2 Regulatory Background

As it is quite common to see commercial contracts with a delivery date sometime in the future, the distinction between regulated "futures" contracts and

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<sup>7</sup> [2003] 1 Lloyd's Rep 279.

<sup>8</sup> *Id.*, at 281.

<sup>9</sup> *Id.*, at 280.

<sup>10</sup> The law applicable to the *CR Sugar* case was the FSA 1986. However, a large part of the regulatory texts regarding the meaning of option and futures are the same as those under the current Financial Services and Markets Act 2000 (FSMA 2000). The following discussion is based on the FSMA 2000. Relevant texts in the FSA 1986 are reproduced in Appendix 1 of this thesis.

unregulated commercial contracts for future delivery represents the difficulty in distinguishing regulated futures contracts on the one hand from purely commercial sale of goods. An unavoidable result is that some forward contracts or options to enter into a future sale might fall under futures regulation, which poses a threat to market participants. To save space here, the relevant statutes are reprinted in Appendices 1 (UK law) and 2 (US law).

### 3.1.2.1 UK Law

In the UK, “futures” are a kind of regulated investment. The term “futures” is defined as “rights under a contract for the sale of a commodity or property of any other description under which delivery is to be made at a future date and at a price agreed on when the contract is made”.<sup>11</sup> A price is deemed to be agreed on when the contract is made, even if the price refers to the futures market.<sup>12</sup> The Regulatory Activities Order 2001 (RAO 2001) refines this definition by excluding “rights under any contract which is made for commercial and not investment purposes”.<sup>13</sup> The RAO 2001 further provides several guidelines to determine whether a commodity contract with a fixed price and a future delivery date is for commercial or for investment purposes.

First, a “contract is to be regarded as made for investment purposes if it is made or traded on a recognised investment exchange”.<sup>14</sup> In contrast, when a contract is not traded on a “recognised investment exchange”,<sup>15</sup> it is to be

“regarded as made for commercial purposes if under the terms of the contract delivery is to be made within seven days, unless it can be shown that there existed an understanding that (notwithstanding the express terms of the contract) delivery would not be made within seven days.”<sup>16</sup>

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<sup>11</sup> Financial Services and Markets Act 2000 (Regulatory Activities) Order 2001, SI 2001/544 (RAO 2001), article 84(1). We should be aware that the definition in paragraph 18 of the Schedule 2 of FSMA 2000 does not require that the price be agreed on when the contract is made.

<sup>12</sup> See RAO 2001, article 84(8).

<sup>13</sup> *Id.*, article 84(2).

<sup>14</sup> *Id.*, article 84(3).

<sup>15</sup> See FSMA 2000, section 285 *et seq.*

<sup>16</sup> RAO 2001, article 84(4).

Secondly, the main difficulty occurs where a contract is neither traded in a recognised exchange nor deemed to exist for commercial purposes, either because delivery is not required within seven days or no existing understanding can be proved. Thus, the RAO 2001 provides certain “indications” for use in such eventualities. On the one hand, a contract might be made for commercial purposes if one party is the producer of the commodity or if one uses it in his business or if the seller intends to make delivery (or the buyer intends to accept delivery).<sup>17</sup> It is also an indication that a contract is made for commercial purposes if the terms of the contract are tailor-made by parties for that particular trade and “not by reference (or not solely by reference) to regularly published prices, to standard lots or delivery dates or to standard terms”.<sup>18</sup> In contrast, it is an indication that a contract is made for investment purposes if it is expressed to be as traded on an investment exchange, if the performance of the contract is ensured by an investment exchange or a clearing house, or if there are arrangements for the payment or provision of margin.<sup>19</sup>

Several lines of reason led Steel J to the conclusion that CR was trading sugar options for investment purposes in *CR Sugar Trading Ltd v China National Sugar and Alcohol Group Corp*<sup>20</sup>, which is the only case in UK law on the definition of “futures”. First, both parties recognised that delivery was not especially desirable.<sup>21</sup> Secondly, Steel J held that “the verb ‘to use’ connotes the process of putting into service or consuming material”, which neither party was doing at that moment. Thirdly, Steel J rejected CR’s submission that “once the option is exercised, it is replaced by the sale agreements”, from which premise the intention to make delivery could be inferred;<sup>22</sup> furthermore Steel J held that the time to determine the intention of the parties was when the contract (i.e. the options) was made.<sup>23</sup>

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<sup>17</sup> *Id.*, article 84(5).

<sup>18</sup> *Id.*, article 84(6).

<sup>19</sup> *Id.*, article 84(7).

<sup>20</sup> [2003] 1 Lloyd’s Rep 279.

<sup>21</sup> *Id.*, at 281–283.

<sup>22</sup> *Id.*, at 284.

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

The *CR Sugar* case was rather interesting and might have a serious effect on the commodity market. As Henderson observes, “[i]t is not at all clear how far up (or down...) the distribution chain one must be before one is a user”.<sup>24</sup> CSW, the Chinese company, was the only beneficiary of the *CR Sugar* judgment as it earned premiums from CR and had no obligation under English law to take delivery of the sugar. It is not known if CR tried to reclaim the premiums from CSW.<sup>25</sup> If it did, CR might have had to go to China to recover its money. CR probably did not have this scenario in mind when it first entered into options trading with CSW. We will revisit to the *CR Sugar* case at the end of this chapter.

### 3.1.2.2 US Law

In the US, the Commodity Exchange Act (CEA) provides that it should be unlawful for any person to enter into “a contract for the purchase or sale of a commodity for future delivery” unless “such transaction is conducted on or [is] subject to the rules of a board of trade which has been designated or registered by the [CFTC] as a contract market” and is “executed or consummated by or through a contract market”.<sup>26</sup> The term “board of trade” means “any organized exchange or other trading facility.”<sup>27</sup>

The definition of “commodity” includes a lengthy list of agricultural products and the general phrase “all other goods and articles ... and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in”.<sup>28</sup> Sugar, although not clearly listed, was held to be a commodity under the CEA.<sup>29</sup> A contract for the sale of precious metals, or crude or natural gas, has also been held to be within the jurisdiction of the Commodity Futures Trading

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<sup>24</sup> Henderson, Henderson on Derivatives, at 12.19 (LexisNexis Butterworths, 2003).

<sup>25</sup> Cf. local authority cases discussed in *supra* 2.3.1.

<sup>26</sup> 7 USCA 6.

<sup>27</sup> 7 USCA 1a(2).

<sup>28</sup> 7 USCA 1a(4).

<sup>29</sup> *Poplar Grove Planting & Refining Co v Bache Halsey Stuart, Inc*, 465 F Supp 585 (1979).

Commission (CFTC).<sup>30</sup> Nevertheless, retail contracts for foreign currency traded off exchanges are excluded from the CEA.<sup>31</sup>

More legal problems are raised by the so-called “cash forward” exception. The CEA provides that “[t]he term ‘future delivery’ does not include any sale of any cash commodity for deferred shipment or delivery”.<sup>32</sup> The main purpose of this exception was “to meet a particular need such as that of a farmer to sell part of next season's harvest at a set price to a grain elevator or miller. These cash forward contracts guarantee the farmer a buyer for his crop and provide the buyer with an assured price. Most important, both parties to the contracts deal in and contemplate future delivery of the actual grain.”<sup>33</sup>

The application of the cash forward exception is not as straightforward as the statutory texts might suggest. In *CFTC v Co Petro Marketing Group*<sup>34</sup>, the leading authority for the interpretation of cash forward exception, Co Petro offered and sold to customers contracts for the future purchase of petroleum products. Under their agreement,

“the customer (1) appointed Co Petro as his agent to purchase a specified quantity and type of fuel at a fixed price for delivery at an agreed future date, and (2) paid a deposit based upon a fixed percentage of the purchase price. Co Petro, however, did not require its customer to take delivery of the fuel. Instead, at a later specified date the customer could appoint Co Petro to sell the fuel on his behalf. If the cash price had risen in the interim, Co Petro was to (1) remit the difference between the original purchase price and the subsequent sale price, and (2) refund any remaining deposit. If the cash price had decreased, Co Petro was to (1) deduct from the deposit the difference between the purchase price and the subsequent sale price, and (2) remit the balance of the deposit to the customer. A liquidated damages clause provided that in no event would the customer lose more than 95% of his initial deposit.”<sup>35</sup>

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<sup>30</sup> See for example, *CFTC v Co Petro Marketing Group*, 680 F 2d 573 (1982); *CFTC v PIE Inc*, 853 F 2d 721 (1988).

<sup>31</sup> See 7 USCA 2(c). There were disputes regarding whether off-exchange options for sale of foreign currency were within the jurisdiction of the CFTC. In *Dunn v CFTC*, 519 US 465 (1997), the US Supreme Court held that off-exchange options to foreign currency were outside the CEA. However, the Commodity Futures Modernization Act of 2002 revised the CEA and retail future delivery foreign exchange transactions are currently regulated by the CFTC. See also *CFTC v Zelender*, 373 F 3d 861 (2004).

<sup>32</sup> 7 USCA 1a(19).

<sup>33</sup> *CFTC v Co Petro Marketing Group*, 680 F 2d 573, at 577–578 (1982).

<sup>34</sup> 680 F 2d 573 (1982).

<sup>35</sup> *Id.*, at 576.

Co Petro's contracts are very much like exchange-traded futures except that Co Petro is not an organised exchange and customers may not trade contracts with each other.<sup>36</sup> The CFTC brought an injunctive action to stop Co Petro from selling such products and Co Petro argued that their contracts fell within the cash forward exception. On the matter of whether the contracts sold by Co Petro were contracts of a commodity for future delivery, the court held that "no bright-line definition or list of characterizing elements is determinative. The transaction must be viewed as a whole with a critical eye toward its underlying purpose".<sup>37</sup> The court did compare Co Petro's contracts with exchange-traded futures, as Co Petro argued that it was not an organised exchange. Nevertheless, the court cited the broad definition of "board of trade" and decided that "[t]he contracts here represent speculative ventures in commodity futures which were marketed to those for whom delivery was not an expectation".<sup>38</sup>

As to the cash forward exception, the court held that "[t]here is nothing in the legislative history surrounding cash forward contracts to suggest that Congress intended the exclusion to encompass agreements for the future delivery of commodities sold merely for purposes of such speculation."<sup>39</sup> Thus, the court concluded

"[w]e hold, therefore, that this exclusion is unavailable to contracts of sale for commodities which are sold merely for speculative purposes and which are not predicated upon the expectation that delivery of the actual commodity by the seller to the original contracting buyer will occur in the future."<sup>40</sup>

In the end, Co Petro was held to violate the CEA.

The *Co Petro* case represents a situation where an off-exchange contract might be seen as a regulatory "futures" contract. The *Co Petro* case is relatively easy to tackle as no clause in the contract required delivery and the structure of

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<sup>36</sup> In fact, Co Petro did apply to the CFTC but failed to acquire a license as a designated contract market. *Id.*, at 581.

<sup>37</sup> *Id.*, at 581. This is later referred to as the "totality of circumstances" test. *See infra* 3.3.1.

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

<sup>39</sup> *Id.*, at 579.

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

transactions was quite similar to exchange trading.<sup>41</sup> It would be too cumbersome to have a full account of case laws on the interpretation of the language of the CEA after *Co Petro*. Some of the arguments involved will be introduced below when we discuss certain special types of transactions (see 3.3. below). At this stage, it should be noted that the intention of parties to deliver under a contract is an important criterion for determining whether the cash forward exception applies to this contract.

### 3.1.3 Issues for Commodity Traders

It is necessary to clarify the usage of the terms “futures” and “forward” under both UK and US law. In general, market participants use “futures” to refer to exchange-traded contracts and “forward” to indicate contracts for future delivery of an organised exchange (see 2.2.2.1 below). However, both UK and US law use the term “futures” to describe contracts for the sale of a commodity for future delivery at prices fixed when the contract is made. The term “forward” is not used in the RAO 2001. Instead, the RAO 2001 uses “investment purpose” and “commercial purpose” to separate regulated “futures” from unregulated ones. In contrast, the term “forward” is used as an exception to the meaning of “futures” under US law.

It is important to note that the risk of a contract being regulated as a futures contract is not something that can be contracted out. Under the RAO 2001,

“[a] contract ... is to be regarded as made for commercial purposes if under the terms of the contract delivery is to be made within seven days, unless it can be shown that there existed an understanding that (notwithstanding the express terms of the contract) delivery would not be made within seven days.”<sup>42</sup>

Thus, even if parties have inserted a fixed delivery term, a contract might still be seen as a regulated “futures” contract if it can be proved that the parties have had other thoughts on the matter. Under US law, a court would review the totality of

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<sup>41</sup> The contractual structure of exchange trading will be introduced in *infra* 3.2.

<sup>42</sup> RAO 2001, article 84(4).

circumstances rather than relying on the delivery terms stated in the contract in order to determine whether the transaction is a futures contract.

The UK and US regulations raise two questions: “What are ‘futures’ in the eyes of the law?” and “why do we regulate ‘futures’?” UK law provides certain guidelines for deciding whether a future delivery contract is for commercial purpose or for investment purpose. What is not fully explained in the *CR Sugar*<sup>43</sup> judgment is the reason for regulating future delivery contracts for investment purposes. Organised exchanges are undoubtedly the focus of regulation (see 3.2.4 below). Nevertheless, as this discussion will show, most legal uncertainties from the legal meaning of “futures” fall on off-exchange commodity contracts. If we accept that commodity exchanges and individual commercial sales represent the two poles of commodity trading, what remains to be decided is the boundary between regulated “futures” contracts and unregulated commercial future delivery contracts. As neither CR nor CSW was a bank or a typical financial institution, it is interesting to ask how far the FSMA 2000 could interfere with trading business between two non-financial institutions. This is a question that will be borne in mind throughout the present chapter.

It is worth noting that the meaning of “futures” need not be the same in both the UK and the US. As will be indicated later, each country might have its own policy concerns. The FSMA 2000 is more flexible, such that a transaction not classified as “futures” might still be seen as a contract for differences if it allows cash settlement.<sup>44</sup> In contrast, US law does not have such luxury. However, both UK and US law are comparable in the case of contracts requiring physical delivery. In the following sections, we will first introduce the contractual structure of exchange trading in order to identify factors that distinguish exchange trading from other transactions and reasons why exchange trading should be regulated; then we will consider several cases in the UK and in the US

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<sup>43</sup> [2003] 1 Lloyd's Rep 279.

<sup>44</sup> RAO 2001, article 85.



concerning off-exchange commodity trading contracts and the boundary between regulated and unregulated contracts.

## 3.2 Contractual Structure of Exchange

### Trading

The futures market is highly standardised. It is easy to assume that exchange trading is based on rules and to ignore the fact that major international futures exchanges are still private institutions (like companies or mutual associations) and that exchange trading is still largely based on contracts. It is also through contracts that exchange or clearing rules become binding. This section will first briefly introduce how a futures exchange<sup>45</sup> and the clearing system operate. Then the focus will shift to the contractual structure of futures trading and to how a contractual position can be settled either by entering into a contrary trade or by making delivery.

#### 3.2.1 Trading Systems

Traditionally, the trading of futures is conducted in a physical space. The trading floor is usually in the shape of an octagonal or polygonal ring with steps leading off to the “pits” which traders occupy.<sup>46</sup> There are usually large screens to show current market prices, weather conditions, and information from relevant markets (e.g. the securities market, currency market, cash market).<sup>47</sup> When a trader wants to trade a certain number of contracts, he stands in his pit and calls out to other traders with the help of hand signals to communicate trading information (the number of contracts and the prices at which he is willing to trade). From this practice comes the name “open outcry”.<sup>48</sup>

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<sup>45</sup> The meaning of “exchange” is not free from question. See Lee, *What Is An Exchange?: The Automation, Management, and Regulation of Financial Markets* (OUP, 2000). In this thesis, we focus on current established exchanges, and thus avoid the question whether a trading system may be defined as an exchange.

<sup>46</sup> Chicago Board of Trade, *Commodity Trading Manual*, at 31 (Glen Lake Publishing, 1997).

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

<sup>48</sup> The film *Rogue Trader* (1999), based on the infamous Nick Leeson story and the collapse of Barings Bank, is a good big-screen illustration of how open outcry works.

Once one trader has found another who is willing to deal with him at an agreed price, the deal is submitted to the exchange and the new price shown on the big screen in the trading floor so that all traders are up to date with the new market price. Price information is also disseminated to clients via brokers and sent to outside information vendors via the exchange.<sup>49</sup> The new transaction is then reported to the clearing system for final settlement. Under the open outcry system, the trading floor effectively becomes a place for discovering prices.

Not everybody can enter the trading floor and start trading. The number of traders is limited by membership (often requiring a substantial membership fee).<sup>50</sup> In general, there are three types of floor traders at a futures exchange. First, some floor traders are employed by a commission house or a broker to fill the orders of its clients. They simply represent the commission house or the broker. The second type is often called “independents”—self-employed traders filling outside orders for other brokers, financial institutions, or commercial entities. The third type, “locals”, trade on their own account.<sup>51</sup> In legal terminology, a trader who executes orders for other persons is called a “broker” in England and a “floor broker” in the US; while one who executes orders on his own account is generally called a “local” in the UK and a “floor trader” in the US.<sup>52</sup>

In the Internet era, electronic trading seems to have become an unstoppable trend.<sup>53</sup> In an electronic trading system, traders must acquire and install licensed software on their computers. Using the Internet, traders can connect to the electronic trading platform and submit an order, and even cancel or modify it

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<sup>49</sup> *Supra* note 46, at 33.

<sup>50</sup> For example, the Chicago Board of Trade (CBOT) stipulates detailed rules regarding membership applications, fees, transfer of membership, etc. *See* CBOT Rule Chapter 2. In fact, a “seat” in the CBOT is such a valuable asset that there exists a market for it. The latest prices for a seat in the CBOT can be found at <http://www.cbot.com/cbot/pub/page/0,3181,935,00.html> (visited on 16 Oct 2006). *See also* CME Rule, chapter 1.

<sup>51</sup> *Supra* note 46, at 34.

<sup>52</sup> *See* FSA Handbook, Glossary; and 7 USCA 1a(16) and 1a(17).

<sup>53</sup> For example, the LIFFE CONNECT system of the London International Financial Futures Exchange (LIFFE); e-cbot of the CBOT; and the GLOBEX of the CME. The ICE Futures (former International Petroleum Exchange), the London Metal Exchange (LME), and the New York Mercantile Exchange (NYMEX) also embrace electronic trading platform.

before execution (subject to exchange rules).<sup>54</sup> The system then matches one order with another in order to determine whether the order should be executed (i.e. matched in whole or in part by another trader). Like the open outcry system, once an order is matched with another order, it then enters the clearing process.

The existence of the clearing system is one distinguishing characteristic of exchange trading. A clearing services provider (“clearing house”) can be an independent institution or a body affiliated with the exchange itself. For example, the London Clearing House (LCH) is separate from its exchange clients, such as the London International Financial Futures Exchange (LIFFE), the London Metal Exchange (LME), and the London Stock Exchange (LSE); but the Eurex Clearing AG, the clearing house for the Eurex in Europe, is the exchange’s subsidiary.<sup>55</sup> An exchange may also use the clearing services of a rival exchange. For example, from April 2003, all trading conducted at the Chicago Board of Trade (CBOT) is cleared through the clearing services of the Chicago Mercantile Exchange (CME).<sup>56</sup>

Only members (“clearing members”) have a direct relationship with the clearing house. Thus, if a trader is both an exchange member and a clearing member, he can enter into a trade in the exchange and clear through the clearing system on his own account. In contrast, if an exchange member is not a clearing member, he must enter into a “clearing agreement” with a clearing member, and all his trades must be cleared through that clearing member in the clearing system. All exchange trades must enter into the clearing system, and no trade can be committed by an exchange member without being a clearing member or having a clearing agreement.<sup>57</sup>

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<sup>54</sup> See GLOBEX Brochure, at 10

<<http://www.cme.com/files/GLOBEX%20brochure%20final.pdf>> (visited on 16 Oct 2006).

<sup>55</sup> See <[http://www.eurexexchange.com/about/corporate\\_structure\\_en.html](http://www.eurexexchange.com/about/corporate_structure_en.html)> (visited on 3 December 2006).

<sup>56</sup> See <<http://cbot.com/cbot/pub/page/0,3181,1150,00.html>> (visited on 4 December 2006). The CME then merged with the CBOT in 2007 to form the largest financial futures exchange group in the world.

<sup>57</sup> In the LIFFE, parties to this clearing agreement include the non-clearing member, the clearing member, the exchange (LIFFE), and the London Clearing House. See LIFFE Rules, Book 2, section 3.3 & section 4.11.1, and the LCH Procedures section 2A.3.2. In the CBOT, a

One important function of the clearing house is to ensure the performance of all contracts by stepping into the contractual relationship between the two parties.<sup>58</sup> Another function is to calculate the net number of contracts (called “positions”) held by each trader (or clearing member) in order to determine the amount of collateral (called “margin”) that traders must maintain. As will be explained below, this structure helps minimise the credit risk involved. These issues will be discussed in more detail later.

## 3.2.2 Contractual Structure

### 3.2.2.1 Introduction

Before any further discussion, it should be made clear that all relevant parties in the futures market are contractually bound before entering into any trade. Exchange members are bound by their membership agreements and exchange rules.<sup>59</sup> Clearing members are bound by their membership agreements and clearing rules. A non-clearing member must have a clearing agreement with a clearing member. An outside investor must have a brokerage agreement with his broker. Thus, before any order is submitted, all relevant market participants are bound by certain contractual arrangements, and without these contracts they cannot trade in the exchange.

On the basis of the above description, we can assess how futures contracts are concluded and how they pass through the clearing process. To help answer these questions, we will examine two cases in order to compare and contrast different exchanges. In Case 1, *A* and *B* are both members of the exchange and the clearing house associated with that exchange. *A* would like to buy 1,000 contracts and *B* would like to sell 1,000 contracts for the same type of futures. In Case 2, private investors *E* and *F* would like to invest in the futures market (it

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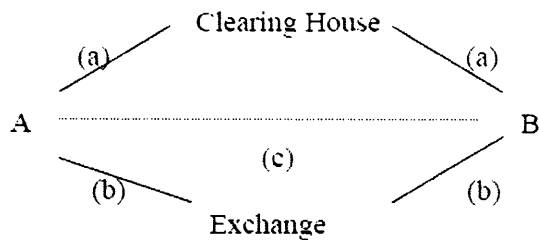
non-clearing member must have a clearing agreement with a clearing member, who becomes the “primary clearing member” for that non-member. The existence of a primary clearing member is the pre-condition to trading by non-members. See CBOT Rule 207.01. See also NYMEX Rules 2.21 & 6.11.

<sup>58</sup> See LIFFE Rules, Book 2, section 4.11.

<sup>59</sup> Exchanges frequently bind all relevant participants to their exchange rules rather than solely exchange members. For example, see CBOT Rule 205.00.

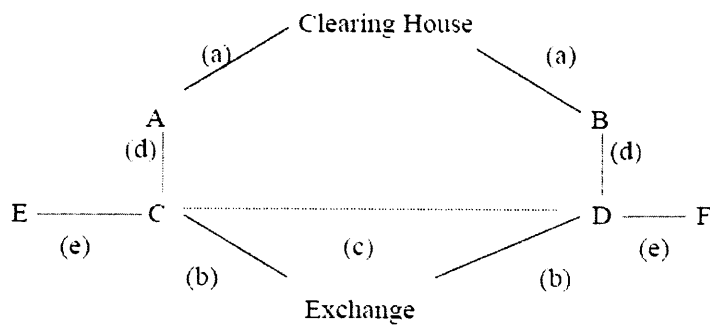
is assumed they invest in the same type of contract due to mature in the same month). *E* instructs his broker *C* to place an order in the market to buy 100 contracts and *F* instructs his broker *D* to sell 100 contracts. Neither *C* nor *D* is a member of the clearing house, so each has a clearing agreement with a clearing member (*A* and *B* respectively). Cases 1 and 2 are illustrated in Charts 3-1 and 3-2, respectively:

Chart 3-1



- (a) Clearing Membership
- (b) Exchange Membership
- (c) Exchange Contract

Chart 3-2



- (a) Clearing Membership; (b) Exchange Membership; (c) Exchange Contract;
- (d) Clearing Agreement; (e) Brokerage Agreement.

### 3.2.2.2 Formation of a Position

One difficulty with exchange trading arises from the fact that trading is conducted among multiple traders in the ring or on the electronic platform. If all transactions between any two original traders who make a transaction in the pit (or whose orders are matched by the electronic system) were enforced, it would be difficult for traders to perform and to liquidate open contracts because there might be hundreds of combinations between any two given exchange members (depending on the total number of members). The clearing system cannot operate smoothly without first reducing the number of contractual parties. In addition, the contractual structure has to be carefully designed to ensure that contractual obligations can be transferred from the exchange to the clearing system without raising any legal problem.

The following sections focus on rules and practice at the LIFFE and the CBOT. It should be borne in mind that this thesis does not suggest that the LIFFE is representative of UK exchanges, or that the CBOT is the typical American model. Rather, they are chosen to illustrate different structures and because grain futures are traded on both exchanges. The rules and practices of other major exchanges will also be mentioned briefly.

#### 3.2.2.2.1 LIFFE

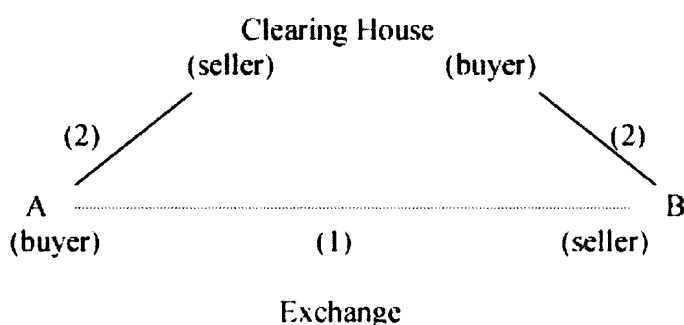
Do Cases 1 and 2 create a new contract? In Case 1 above, *A* and *B* agree upon the number of contracts and the price on the trading floor. The LIFFE rules have dealt with the formation issue, stating that the “[v]alid acceptance of a valid bid or offer shall make a [transaction] between the members whose traders made the bid or offer and the acceptance”.<sup>60</sup> In the present case, 1,000 futures contracts (“exchange contracts”) are made between *A* and *B*. Once this transaction has been recorded and reported, it will be transferred to the LCH, who will then step into the contractual relationship governing this transaction. Thus, the original contractual relationship will be “novated” and become two contractual

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<sup>60</sup> LIFFE Rules, Book 1, section 5304/1.

relationships (between *A* and the LCH, and between *B* and the LCH).<sup>61</sup> The process is illustrated in Chart 3-3 below.

Chart 3-3



\* The original exchange contract (1) will be novated into two identical contracts (2), where the clearing house acts as the seller against *A* (the buyer) and as the buyer against *B* (the seller).

Case 2 is more complicated. Once *C* and *D* execute their clients' orders (*E*'s and *F*'s orders respectively), an exchange contract will exist between *C* and *D* (as brokers) similar to that between *A* and *B* above. Because *C* and *D* are not clearing members, they must clear through *A* and *B*, who are clearing members and with whom they have a clearing agreement.<sup>62</sup> After the exchange transaction is sent to the clearing house and confirmed by the relevant clearing members (*A* and *B* in this case), according to the LIFFE Rules, a contract (called a "parallel contract") will arise between the clearing members and the non-clearing members (i.e. between *A* and *C* and between *B* and *D*). This contract has terms identical to those of the original exchange contract (called the "original contract").<sup>63</sup> The parallel contract also discharges the clearing

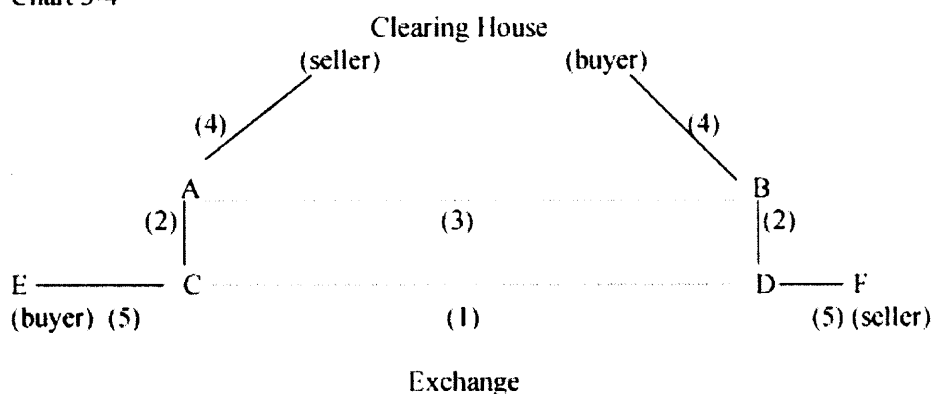
<sup>61</sup> Rules of the LIFFE and the LCH explicitly use the term "novation". See LIFFE Rules, Book 2, sections 4.11.1 & 4.12.4; LCH General Regulations, Regulation 3. Its meaning will be discussed in *infra* 3.2.2.2.3.

<sup>62</sup> See LIFFE Rules, Book 2, section 4.11.1.

<sup>63</sup> Under the parallel contract, the clearing member (*A*) will stand in the place of the opposite party (*D*) against the non-clearing member (*C*). See LIFFE Rules, Book 2, section 4.12.1.

members *A* and *B* from their “responsibility of guarantee and indemnity” for *E*’s and *F*’s performance.<sup>64</sup> Furthermore, simultaneously with the creation of the parallel contract, another contract (called a “related contract”) with terms identical to those of the original contract will arise between the two clearing members *A* and *B*.<sup>65</sup> According to the LIFFE rules, the original contract will be discharged by novation through the parallel and related contracts.<sup>66</sup> Finally, the LCH will step into the relationship between *A* and *B*, as in Case 1 (see Chart 3-4 below).

Chart 3-4



\* The original exchange contract (1) will be novated into a series of identical contracts between different parties. First, a parallel contract (2) will arise between the clearing member and the exchange member. Secondly, a related contract (3) will arise between the two clearing members. Then, the clearing house will intervene so that the related contract is novated into two contracts (4). The relationship between the client and an exchange member is determined by their brokerage or agency agreement (5).

Therefore, at the LIFFE, a simple exchange contract between two traders (in Case 2, *C* and *D*) will automatically be transformed into a series of identical contracts between non-clearing members and the clearing members, between two clearing members, and eventually between clearing members and the clearing house. In addition, it should be noted that, under LIFFE’s rules, all exchange members are

<sup>64</sup> LIFFE Rules, Book 2, sections 4.11 & 4.12.4.

<sup>65</sup> Under the related contract, *A* will stand in place of *C*, and *B* in place of *D*. See LIFFE Rules, Book 2, section 4.12.2 and 4.12.3.

<sup>66</sup> LIFFE Rules, Book 2, section 4.12.4.



deemed to act as principals, whether they trade for themselves or for third parties.<sup>67</sup> Thus, in Case 2, even if *C* and *D* execute orders to *E* and *F*, for the exchange contract, *C* and *D* are the contractual parties. The relationships between *E* and *C* and between *F* and *D* are determined by the respective brokerage agreements.

### 3.2.2.2.2 CBOT

The contractual structure of trading and clearing at the Chicago Board of Trade (CBOT) is similar, but differs slightly from the LIFFE model. With respect to Case 1, the situation is very much the same. Once the trade has been registered with the clearing house, the latter will step into the relationship between *A* and *B*. Thus, one contract becomes two contracts.<sup>68</sup>

In Case 2, under US federal law, *C* and *D* are each considered a “futures commission merchant” (FCM), which is generally defined as a person (legal or natural) who solicits and accepts orders from a third party and who receives money or property as margin or security.<sup>69</sup> An FCM trades in his own name and becomes liable as principal between himself and the other party.<sup>70</sup> Thus, when *C* and *D* make trades on behalf *E* and *F*, they trade under their own names rather than those of their clients. However, since *C* and *D* are not clearing members, they must acquire authority from their clearing members (*A* and *B* respectively) to conduct trading. According to CBOT rules, in this situation “[s]uch [clearing member] shall guarantee and assume complete responsibility for all trades and orders executed or directed to be executed by such non-clearing member”.<sup>71</sup> (See Chart 3-5 below)

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<sup>67</sup> LIFFE Rules, Book 2, section 4.10.3.

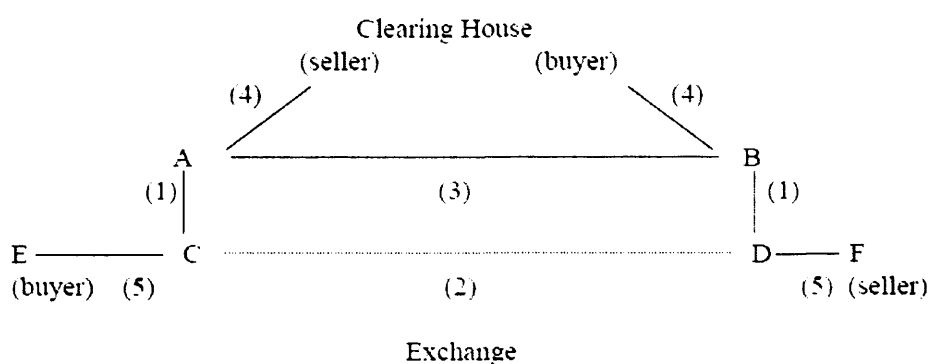
<sup>68</sup> CBOT Rule 704; CME Rule 804.

<sup>69</sup> 7 USCA 1a(20). In contrast, an “introducing broker” is a person who solicits and accepts orders from a third party but who does not receive money or property as margin or security. 7 USCA 1a(23).

<sup>70</sup> CBOT Rule 400.00.

<sup>71</sup> CBOT Rule 207.01(a).

Chart 3-5



\* In the CBOT, a non-clearing member can conduct trading provided that it acquires the authority (1) from its primary clearing members(A & B). Trading (2) is done by C and D, but the exchange contract (3) exists directly between the clearing members (A and B). Then the clearing house will intervene and novate the exchange contract into two contracts (4). The relationship between clients and exchange members is determined by their respective brokerage agreements (5).

Once a trade is agreed upon and registered with the clearing house, the clearing house becomes the principal who is liable to *C* and *D* (as *A*'s and *B*'s customers) and to whom *C* and *D* are liable.<sup>72</sup> However, this trade may be offset against other trades by the clearing members (i.e. *A* and *B*).<sup>73</sup> The last rule is quite confusing as it is not clear whether the clearing house has a direct contractual relationship with *C* and *D*. However, the CBOT does not really change the role of clearing members but clarifies the relationship between a clearing member and a non-clearing member. The same rule further provides that

“if the trade is not offset and the Clearing Member being a seller, tenders a delivery notice to the Clearing Services Provider, the Clearing Member to whom such delivery is assigned shall thereupon be substituted as buyer in lieu of the Clearing Services Provider”.<sup>74</sup>

The reverse holds in the event that the clearing member is a buyer. The same rule also states that “if the trade is offset, the Clearing Services Provider shall be

<sup>72</sup> CBOT Rule 706.00; CME Rule 804.

<sup>73</sup> CBOT Rules 705 & 706, and CME Rules 804 & 806.

<sup>74</sup> CBOT Rule 706, items (c) & (d).

discharged, and the Clearing Member itself shall be substituted for the Clearing Services Provider as principal.”<sup>75</sup> It continues:

“[u]pon such substitution, each clearing member [should] be deemed to have bought the contracts from or sold the contracts to the Clearing House, ..., and the Clearing House [should] have all the rights and be subject to all the liabilities of such member with respect to such transaction.”<sup>76</sup>

Thus, if delivery is made following clearing rules, the CBOT discharges the clearing house and makes a clearing member party to the futures contract against a non-clearing member. A buyer-clearing member should in turn pass the delivery to the non-clearing member. In essence, the CBOT creates a contractual relationship between the non-clearing member and the clearing member if delivery is made so that deliveries can be transferred from clearing members to non-members or to the original buyers. The structures of the LIFFE and the CBOT, though different, yield the same conclusion.

### **3.2.2.2.3 Certain Formation Issues**

As the above description shows, a contractual relationship must exist between relevant parties before a trade is submitted, and the rules of the exchange and the clearing house largely formulate the legal relationships under which trading can be conducted. A few issues on the formation of futures contracts are addressed in the following paragraphs.

First, is a new contract made when two traders agree on the price and the amount of the quantities? At the LIFFE, every futures product has its own standard contract.<sup>77</sup> Once an agreement has been reached (or orders matched by the electronic system), a new contract is made between the two traders. In contrast, at the CBOT, terms governing each exchange contract are incorporated in the

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<sup>75</sup> *Id.*, item (e).

<sup>76</sup> CME Rule 804.

<sup>77</sup> Each futures contract at the LIFFE has a numerated standard contract. For example, the Wheat Futures Contract is listed as Exchange Contract No. 405 and the Cocoa Futures Contract is Exchange Contract No. 401. At the LIFFE, the standard contract for each futures product comprises proper terms and conditions, from prices, quantity and quality to settlement, governing law and dispute resolution.

exchange rulebook.<sup>78</sup> However, while the CBOT plays down the concept of individual “exchange contract”, exchange rules explicitly use the words “futures or options contract”<sup>79</sup>, which clearly indicates that an individual exchange contract is made in the first instance because it is the source of obligations in each individual transaction.

Secondly, a more interesting question is how the exchange trading system can “guarantee” the performance of exchange trading contracts. The goal is to allow a clearing house to step into the original trading contracts so that it can effectively “guarantee” (in a literal sense) the performance of all contracts. Exchange and clearing rules should be read carefully. When the term “guarantee” is used in exchange rules, it might not mean the same as when it is used in an independent contract of guarantee made by the clearing house.

In the LIFFE/LCH system, the term “novation” is used to describe such a “stepping into” process. The exact legal meaning of “novation” is not always clear.<sup>80</sup> Nevertheless, we may assume that the term “novation” used in LIFFE and LCH rules has the same meaning as “novation” used in common law; so the clearing house steps into the trader’s shoes and eventually become the ultimate contractual party (in relation to each responsible clearing member).<sup>81</sup>

In contrast, the CBOT/CME system uses a more obscure term “substitution” instead of “novation”. In practice, “substitution” in the LIFFE/LCH system might not be any different from “novation” in the LIFFE/LCH system. After all, the goal of such substitution is to allow the clearing house to become one of

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<sup>78</sup> The complete list can be seen at <<http://www.cbot.com/cbot/pub/page/0,3181,931,00.html>> (visited on 17 Oct 2006).

<sup>79</sup> For example, see CBOT Rule 704.00 (Substitution).

<sup>80</sup> In English law, novation seems to mean a new contract between the original contractual parties and a third party. Since a new contract is formed, consideration is required. See *Aktion Maritime Corporation of Liberia v S Kamas & Brothers Ltd (The Aktion)* [1987] 1 Lloyd's Rep 283; *Rasbora Ltd v JCL Marine Ltd* [1977] 1 Lloyd's Rep 645; *Customs and Excise Commissioners v Diners Club Ltd* [1989] 1 WLR 1196. However, in theory, novation might also be seen as a combination of assignment of rights and assumption of liability by a third party such that no new contract is needed.

<sup>81</sup> See also Goode, *Legal Problems of Credit and Security*, at 7-18 (3rd ed., Sweet & Maxwell, 2003).

the contractual parties to a trading contract. However, whether such substitution is legally equivalent to “novation” is not crystal clear.

Thirdly, can the formation of a futures contract be analysed in terms of offer and acceptance? In the open outcry system, since a transaction is initiated by a pit trader using voice and hand gestures, the exchange of gestures or shouting could be analysed by identifying one message as an offer and another as acceptance. In contrast, if the trading is done electronically, there is no such physical presence or connection. Since two parties are matched by computer, it is difficult to say which order is the offer and which one is the acceptance. The LIFFE rules state that “[i]n the case of [LIFFE CONNECT], the matching of a valid bid with a valid offer by the Trading Host shall constitute the valid acceptance of a valid bid or offer for the purposes of this Rule”.<sup>82</sup> What matters is whether an order is matched rather than whether it is an offer or an acceptance. Under standard practice, the question of offer and acceptance does not have much practical significance.<sup>83</sup>

Fourthly, at what point is the contract deemed to have been made? Although it may appear that a contract has emerged when two traders reach an agreement in the pit, we must examine the whole trading process. In an open outcry system, once two traders commit to a trade, both must send the exchange a message (in paper or electronically) with the details of the transaction. The exchange matches the messages to confirm the trade before submitting it to the clearing house. Thus, we may ask whether the contract is made in the pit or when the trade is registered with the exchange, and whether or not the contract is valid and

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<sup>82</sup> LIFFE Rules, Book 1, section 5304/2. The LIFFE Trading Procedures also state that “an acceptance is defined as the matching of a buy order and sell order in the Central Order Book”. LIFFE Trading Procedures, section 3.2.2(c).

<sup>83</sup> However, whether a trading order is an offer or acceptance might have significant effect if a trader wishes to withdraw his order before it is matched. This problem has been addressed by exchange rules. For example, the LIFFE rules provide that “[o]rders held in the Central Order Book can be withdrawn, individually or as a block, or edited by the relevant Responsible Person or under his authority.” LIFFE Trading Procedures, sections 3.2.7 & 3.2.8. The CBOT rules also provide that “[i]n pit and electronic trading, any bid or offer may be withdrawn at any time before acceptance, but while outstanding, all or any part of any bid or offer is subject to immediate acceptance by any trader. No bid or offer shall be specified for acceptance by a particular trader. The price at which a trade is executed shall be binding, unless such trade is cancelled by Exchange officials in accordance with Exchange rules.” CBOT Rule 523.

enforceable before entering the clearing process. An exchange would provide rules to deal with issues of confirmation and registration issues.<sup>84</sup> Thus, the questions of when the contract is made and when the exchange becomes valid and enforceable should depend on interpretation of exchange rules, which should make it clear how the exchange plans to resolve unconfirmed transactions or mistakes in confirmation messages.

Fifthly, who are the contractual parties? At the LIFFE, taking Case 2 as an example, a contractual relationship would first exist between the two traders (*C* and *D*); then another between the clearing house and the clearing member (e.g. *A*); a further contract between the clearing member and the exchange member (e.g. *A* and *C*); and the last between the exchange member and his client (e.g. *C* and *E*). In contrast, the CBOT takes a different approach. A non-clearing member's authority to trade originates from his primary clearing member. Any trade conducted by a non-clearing member is credited directly to the clearing member's account. Thus, in Case 2, even if there is an actual agreement between *C* and *D*, at first it is *A* and *B* who are contractual parties, followed by clearing house substitution.

Sixthly, since the futures market is so standardised, the "exchange contract" is virtually a minimum unit of trading. Market participants cannot split a contract, but they can combine several "contracts" in a single trade, and the underlying commodities are substituted by the number of contracts traded. For example, if a trader places a single order to trade 10 corn futures contracts for June delivery at the LIFFE, how many contracts are thus created—a single contract or 10 contracts?

Although it is somewhat contrived, it is more convenient and appropriate to treat each "contract" separately, no matter how many "contracts" are traded in a single transaction. The first reason for this is that an order (e.g. to trade 10 contracts) need not necessarily be fully matched at one time with one counterparty. Among the 10 contracts, 2 may be matched by one trader and the other 8 matched

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<sup>84</sup> For example, at the CBOT, a member must confirm with the opposing trader within 15 minutes after each execution of a transaction. See CBOT Rule 350.07.

case the parties' intention would be to take each individual contract as the basic unit of trading.

Lastly, does a new contract arise between a broker (e.g. *C*) and his client (e.g. *E*) if an order is executed? Exchange rules and clearing rules do not go so far as to determine the broker-client relationship. There is no doubt that a broker should pass deliveries to and collect margins from his client (see 3.2.3.1 below). However, whether a new contract is created out of an executed trading order is determined by the brokerage agreements.

### 3.2.3 Performance

Once a contract has been formed, the next stage is performance. What makes the futures market different from other markets is that it allows a trader to liquidate his existing contract by entering into a contrary transaction. Thus, at the end of the trading, only net positions (called “open contracts”, “open positions”, or “open interests”) will lead to delivery (if the underlying contract requires delivery). In this part, we will explain how futures contracts can be liquidated and how delivery can be made.

#### 3.2.3.1 Margin

Before describing how liquidation of futures contracts works, it is necessary to have some understanding of the use of margin in futures exchanges. Margin, like collateral, is not only a mechanism for clearing houses to control the credit risk of market participants<sup>85</sup> but also a way to unify the terms (including prices) of each individual exchange contract.

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<sup>85</sup> The LCH defines it as “security for the performance by such [m]ember of its obligations to the Clearing House”. LCH Regulation 12(a). The CBOT describes it as “indemnity against liability”. CBOT Rule 430.00. The CME literally calls them “security deposit” and

Non-clearing members must now maintain a margin account with a clearing member, while clearing members must keep an account with the clearing house, and clients must maintain an account with their brokers. When making a trade, the trader must pay a certain amount of cash or collateral into the account (generally called “initial margin”) to guarantee performance.<sup>86</sup> In addition, by using the so-called “mark-to-market” strategy on a daily basis, the clearing house adjusts the amount in the margin account to reflect daily profits or losses on futures contracts.<sup>87</sup> If a trader suffers a loss, it is directly reflected in the margin account; if he gains, the margin amount will increase. If the money in the margin account drops below a certain level, the trader must inject more money (called a “maintenance margin”) into the account; otherwise his positions will be liquidated. In turn, a broker-trader should require his client to pay into the margin account in order to maintain his position.<sup>88</sup>

For example, the initial margin for corn futures in the CBOT is US\$1,013 per contract, and US\$750 is the maintenance margin.<sup>89</sup> Let us assume a buyer makes a long corn futures contract at the CBOT at \$5 per bushel.<sup>90</sup> He must first pay \$1,013 into his margin account as the initial margin for this long position. On the next day, if the market price rises to \$5.01 per bushel, he gains \$0.01 per bushel on this contract, and his margin account will be credited with \$50 (from \$1,013 to \$1,063).<sup>91</sup> In contrast, if the price falls to \$4.98 per bushel on the second day, his margin account will be debited with the \$100 loss (from \$1,013 to

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“performance bond”. CME Rule, chapter 8. On several occasions in the early days of the CBOT, when farmers transported the grains to Chicago for delivery, traders simply refused to accept them because the market turned bad. It caused great chaos in trading, and soon prompted the CBOT to step in to maintain the market. The response was the invention of the margin requirement. *Supra* note 46, at 5-6. See also Ezickson, Kremer and Samant, “Exposure Management: Key Issues Affecting Energy Exchange Credit Risk Policy and Procedures” (2007) 22(7) JIBFL 393.

<sup>86</sup> For example, see LCH General Regulations, Regulation 12.

<sup>87</sup> LIFFE Rules Book 2, section 3.27; CBOT Rule 430.00 *et seq.*

<sup>88</sup> LIFFE Rules Book 2, section 3.27.2; CBOT Rules 430.00 & 431.00; NYMEX Rule 4.01; CME Rules 816 & 820.

<sup>89</sup> This is assuming application of the speculative rate. See <http://www.cbots.com/cbot/pub/page/0,3181,2142,00.html#1a> (visited on 17 Oct 2006).

<sup>90</sup> The size of a corn futures contract in the CBOT is 5,000 bushels per contract, and the price is ticked at ¼ cent. See [http://www.cbots.com/cbot/pub/cont\\_detail/1,3206,1213+14389,00.html](http://www.cbots.com/cbot/pub/cont_detail/1,3206,1213+14389,00.html) (visited on 17 Oct 2006).

<sup>91</sup> [(1 cent)\*(5000 bushels)].



\$953). In this situation, since the margin is still above the maintenance level, he need not do anything. However, if the price drops further to \$4.90 per bushel, the margin amount will be marked to \$513 and the buyer must pay an additional \$237 or more to restore the margin to \$750 or more.

The rate of margin is determined by the clearing house,<sup>92</sup> sometimes under the supervision of the financial regulator.<sup>93</sup> With the help of the margin and the intervention of the clearing house, credit risk is greatly reduced because, if a trader cannot afford to fulfil the “margin call”, he will be forced out of the market directly. On the other hand, because of the liquidation of contradictory futures positions, a trader only has to maintain the margin at the level of his net positions at the end of each trading day (see 3.2.3.2 below). Thus, in the end, futures trading is like leverage; a trader only needs to pay a certain amount of money to enter the game; and unless he wants to make or take delivery, he can use limited funds to make big profits.

Clearing houses would prefer the margin to be paid with something having higher liquidity that can be turned into cash as soon as possible. At the LCH, acceptable forms of collateral include cash, bank guarantees, government securities, certificates of deposit, and a certain range of equities.<sup>94</sup> Because of the credit risk involved, the LCH limits the range of currencies, government securities, and equities to those issued by certain institutions.<sup>95</sup> This is similar to other exchanges.<sup>96</sup> If the margin is paid in a foreign currency or in securities, the clearing house faces the risk of depreciation of the value of that currency or those securities. If the value drops below a certain level, the clearing member or the investor will be called upon to restore the margin.<sup>97</sup>

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<sup>92</sup> For example, the margin rate in the CBOT is published online. See <<http://www.cbot.com/cbot/pub/page/0,3181,1041,00.html>> (visited on 17 Oct 2006).

<sup>93</sup> For example, see SEC Rule 15c3-1. 17 CFR 240.15c3-1.

<sup>94</sup> See <[http://www.lch.com/risk\\_and\\_margining/collateral.asp](http://www.lch.com/risk_and_margining/collateral.asp)> (visited on 17 Oct 2006).

<sup>95</sup> Id.

<sup>96</sup> For example, see CBOT Rule 431.02; NYMEX Rules 4.01.

<sup>97</sup> For example, see LCH Regulation 12(j); NYMEX Rules 4.01(C).

### 3.2.3.2 Liquidation of Futures Contracts

Two types of futures contract may be distinguished: one with an obligation for delivery and the other with cash settlement only. The present chapter is concerned with the former type as the open contract can lead to physical delivery.<sup>98</sup> The latter type, settled in cash, is basically a contract for differences traded on exchanges. The liquidation process is the same for both types.<sup>99</sup>

In practice, if a trader has 100 contracts to buy a commodity in a certain delivery month (long positions), a new trading selling 50 contracts of the same description (short positions) will cancel out the same number of existing long positions and only 50 long contracts will be left open if no other transactions are conducted. On the face of it, the “contract” is the basic unit and the process is comparable to a monetary set-off. However, as each exchange contract might have a different contract price, the matter is not as simple as two contracts cancelling each other out and leaving the price to be settled. On the one hand, there could be problems with the requirement of “mutuality”.<sup>100</sup> On the other, even if the two contractual payment obligations can be set off against each other, delivery and other obligations under exchange contracts cannot be offset because they are not monetary debts.<sup>101</sup> Thus, we should examine more carefully how liquidation is accomplished in law.

At the LIFFE, all clearing members must keep accounts with the clearing house (the LCH), which includes a position account and a financial account (for margin purposes). Clients of the clearing member (non-clearing members or non-members) should maintain an account with the clearing member, and so

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<sup>98</sup> For example, at the CBOT open wheat futures contracts must be settled by delivery (or by the EFP). See CBOT Rule 1009.01. At the LIFFE and the LCH, clearing members with open wheat futures contracts at the end of the last trading day are obliged to make or take delivery. See LCH Procedures 5.1.

<sup>99</sup> Liquidation is also often called “close-out”, “netting”, or “settlement”.

<sup>100</sup> Cf. *British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] 2 Lloyd’s Rep 43.

<sup>101</sup> In *Stooke v Taylor*, Cockburn CJ stated that “[b]y the Statutes of Set-off this plea is available only where the claims on both sides are in respect of liquidated debts, or money demands which can be readily and without difficulty ascertained.” (1880) 5 QBD 569, at 575. See also Derham, *The Law of Set-Off*, at sections 2.14 *et seq.* & 3.02 (3rd ed., OUP, 2003); Insolvency Rules 1986, section 4.90.

customers of non-clearing members should do likewise.<sup>102</sup> At the LCH, the liquidation of an open position is done electronically in the position account. If a clearing member is both a buyer and a seller for a certain number of contracts, the net difference is logged: for example, if a trader sells 3 contracts and buys 2 contracts, only 1 net short contract is shown on the net account.<sup>103</sup> On the other hand, if the account is a gross account, the above trades will be registered on a gross basis (i.e. 3 short contracts and 2 long contracts), but the clearing member can settle his positions by manually making an entry into the electronic clearing system. Thus, the result is that with position accounts, only net positions are presented as open contracts.<sup>104</sup>

The approach taken by the LCH requires more careful analysis. Basically, under the LCH regulations, an open contract requires daily settlement and the LCH will mark to the market, calculate the required margin, and enter into a settlement contract (based on the daily settlement price at the end of that trading day) with the clearing member (see 3.2.4.1 below). At the end of each day, every open contract is put through the daily settlement process, and all open contracts must have the same settlement price, regardless of the times and prices at which trades are carried out. Thus, since all contracts are deemed to have the same terms at the end of each day (after the settlement contracts), contrary contract positions can be netted. The settlement process is done before the netting of the positions. Contracts that have not been netted remain open contracts.<sup>105</sup>

The CBOT takes a different, simpler approach. Between a clearing member and the clearing house, where the clearing member buys and sells the same futures or options contract for the same delivery, the purchases and sales will be “offset to

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<sup>102</sup> LCH Procedures 2A.5.

<sup>103</sup> LCH Procedures 2A.5.2.2.1.

<sup>104</sup> LCH Procedures 2A.5.2.2.

<sup>105</sup> LCH General Regulations, Regulation 15.

the extent of their equality”.<sup>106</sup> Between a futures commission merchant and its clients, the situation is the same.<sup>107</sup>

### **3.2.3.3 Delivery**

It is easy to ignore the fact that one may acquire or make delivery of commodities by trading in a commodity exchange. If a futures position is not liquidated before the cessation of trading of a futures contract, and if the contract requires physical delivery, it will enter into the physical delivery process, including transfer of the underlying goods and payment of prices. Following the clearing process, the clearing house operates as middleman to arrange delivery and payment (hereinafter referred to as “standard delivery”). Apart from traditional documentary delivery, the delivery can also be made electronically. A more popular method than standard delivery is to exchange the open contract with a physical spot contract (called the exchange-for-physical, EFP). A variation on the EFP is the exchange-for-swap (EFS). The following sections will describe the process of standard delivery in some leading exchanges and clearing houses and the EFP and EFS operations.

#### **3.2.3.3.1 Standard Delivery**

The standard delivery procedure is detailed in the futures contract, the exchange rules, or the clearing rules. The delivery procedure should reflect the nature of the commodity. Thus, the delivery processes for grains, petroleum, and securities are different. The flexibility of delivery procedures influences how traders use the futures market to conduct physical trading.<sup>108</sup>

First, the novation or substitution of an exchange contract means the clearing house needs to match a seller and a buyer so as to transfer the commodities from the seller to the buyer. At the LIFFE, the LCH acts as an intermediary. Take wheat futures as an example. The standard delivery process at the LIFFE is

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<sup>106</sup> CBOT Rule 705.00. However, under the CME rules, contrary positions are not automatically offset one against the other unless position change data has been submitted to the CME. CME rules 806 & 811.

<sup>107</sup> CBOT Rule 465.02.

<sup>108</sup> The flexibility of delivery rules might also influence how easily a trader might manipulate the market. Romano, *supra* note 2, at 31.

initiated by a seller who, intending to make delivery, should send a delivery notice along with clean wheat warrants to the clearing house during the tender days (i.e. in the last trading month for the contract). In turn, the clearing house will pass the delivery notice, which includes the number of contracts the seller is willing to deliver, on to the buyer.<sup>109</sup> When trading is closed, the exchange publishes a settlement price, and on settlement day<sup>110</sup> the clearing house will make the wheat warrants available to the buyer, debit the account of the buyer, and credit that of the seller to complete the payment.<sup>111</sup>

The LCH remains the buyer (with respect to the original seller) and the seller (with respect to the original buyer), and it transfers the tender or required documents from seller to buyer. The LCH then instructs the buyer where to make payment and the seller where to make delivery. Both seller and buyer must follow these instructions. However, the LCH remains the contractual counterparty to the buyer and seller, even if the physical commodities do not pass through the hands of the LCH.<sup>112</sup>

At the CBOT, standard delivery is similar. The process is also initiated by the seller's notice to the clearing house to indicate his intention to make delivery. The clearing house then assigns the notice to the buyer receiving the delivery.<sup>113</sup> The seller should have acquired the products and all necessary documents by the day of tender, and the buyer should make payment in same day funds. The buyer is then entitled to receive the documents representing the title and/or possession of the goods.<sup>114</sup> It should be noted that the CME rules require a clearing member to liquidate open contracts before the end of trading if a customer is unwilling to make delivery or unable to provide evidence of delivery.<sup>115</sup> The same rules also are used for the West Texas Intermediate

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<sup>109</sup> See LIFFE Exchange Contract No.405 (Wheat Futures Contract) Administrative Procedures, item 5.

<sup>110</sup> "Settlement Day" is defined as the seventh day after the Tender Day or the last day of the Delivery Month. *Id.*, Administrative Procedures, item 8(d).

<sup>111</sup> See generally, LIFFE Exchange Contract No.405 (Wheat Futures Contract) Administrative Procedures.

<sup>112</sup> See LCH General Regulations, Regulations 2, 19, 19A, 20, and 21.

<sup>113</sup> See CBOT Rule 1047.01 & 1049.02, CME Rule 713.

<sup>114</sup> CME Rule 713.

<sup>115</sup> CME Rule 716.

Midland Crude Oil Futures (WTI) at the New York Mercantile Exchange (NYMEX).<sup>116</sup> At the NYMEX, the buyer has to give a notice of intention to accept delivery and the seller has to give a notice of intention to make delivery; the clearing house then matches the notices and determines where the buyer can claim the oil. After the clearing house matches the notices and passes copies of them to the buyer and seller, the buyer must contact the seller for delivery instructions.<sup>117</sup>

While the standard delivery process seems to maintain the structure of documentary trade, delivery can also be made electronically. At the LIFFE or the CBOT, delivery of commodities is carried out by transfer of warrants or warehouse receipts issued by warehouses or grain storekeepers. The buyer who receives the warrants or receipts can claim the corresponding amount of commodities from the warehouse or keeper. In the case of oil or gas trading, commodities can only be claimed at certain oil or gas stations. The NYMEX requires the seller to give the buyer a pipeline ticket to claim the oil or gas.<sup>118</sup> On the other hand, the LME and the LCH have developed an electronic system called the “Sword”, where warrants can be lodged in a depository and transferred electronically between persons with an account in the depository.<sup>119</sup>

Secondly, upon delivery of goods, the buyer has to make payment. At both the LIFFE and the CBOT, the final payment price is determined by the exchange.<sup>120</sup> Basically, the settlement price is the price on the last trading day and is also the invoice price.<sup>121</sup> The price is usually quoted in FOB terms.<sup>122</sup> Once the clearing house transfers to the buyer the invoice it received from the seller, the buyer must pay the seller directly (both the buyer and the seller are clearing

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<sup>116</sup> NYMEX Rule 9.19.

<sup>117</sup> NYMEX Rule 505.15.

<sup>118</sup> NYMEX Rules 505.16 (for WTI crude oil futures).

<sup>119</sup> LME Rules Part 10. See also < [http://www.lme.com/what\\_sword.asp](http://www.lme.com/what_sword.asp) > (visited on 4 December 2006).

<sup>120</sup> CME Rule 813. At LIFFE, the final “exchange delivery settlement price” (EDSP) is published by the exchange. LIFFE, Exchange Contract No. 405, clause 6 (Wheat Futures Contract).

<sup>121</sup> CBOT Rule 1049.03. See also NYMEX Rule 505.15(D) (for the WTI crude oil futures).

<sup>122</sup> CBOT Rule 1049.03; NYMEX Rule 505.14.

members).<sup>123</sup> Because of the daily adjustment of the margin account (see 3.2.3.1 above), the final settlement price does not change the contractual price when the buyer or the seller creates the futures position. For a buyer, if the settlement price is higher than the contract price, his profit is shown in the margin account and he suffers no loss on account of higher invoice price. In contrast, if the settlement price is lower, the buyer's loss is already reflected in the margin, even though he pays less for the invoice,<sup>124</sup> and *vice versa* for the seller.

Thirdly, the title of the underlying commodities has to be transferred. In grain sales, the title is transferred when the seller assigns the warehouse receipt or the warrant issued by the warehouse or the grain storekeeper. For precious metals, the procedure is similar.<sup>125</sup> To secure the quality and quantity of underlying commodities, all exchanges and clearing houses establish qualifications for warehouses. Only qualified warehouses are allowed to issue a recognised warrant or receipt and to make delivery.<sup>126</sup> The exchange also establishes specific rules about sampling and inspection.<sup>127</sup>

For oil or natural gas, the situation is a little different. As crude oil is liquid and natural gas is invisible, neither can be shipped like grain or metal. Because the oil can be transferred by pipelines, delivery and title transfer of WTI oil futures traded in the NYMEX occur when the seller's outgoing pipeline is connected to the buyer's pipeline or storage facilities. In practice, the buyer can either elect to "pump over" by pumping the oil from the seller's facility into his own facility or to take in-line or in-tank transfer. In the latter case, the buyer receives the

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<sup>123</sup> CBOT Rule 1049.04; CME Rule 713.E; LCH General Regulations, Regulation 21. In the NYMEX, the situation is the same. See NYMEX Rule 505.17.

<sup>124</sup> Subject to clearing rules, the buyer's margin could set off the amount of payment due in the invoice so that the buyer only needs to pay the net prices (invoice price minus the amount in the margin account).

<sup>125</sup> For example, for gold futures in the NYMEX, the gold is transferred by warehouse receipt issued by a licensed depository. See NYMEX Rule 113.12. For metals traded in the LME, see LME Rules Part 6 (Special Contract Rules for Metals). It should be noted that section 20A of the Sale of Goods Act 1979 allows unascertained parts of a specific bulk to be transferred so that the commodities can be transferred and delivered lawfully even if the commodities being delivered are not ascertained yet or form only parts of a specific bulk when an exchange contract is made.

<sup>126</sup> For example, see CBOT Rule 1081 *et seq.*; LME Rules Part 4, item 7.

<sup>127</sup> CBOT Rules 1036.00 – 1038.02. LIFFE Exchange Contract No 405 (Wheat Futures Contract), Administration Procedures, item 10.

title for oil, which is stored in a specified facility without being physically moved.<sup>128</sup> Risk of loss is transferred when the oil or natural gas passes through the inter-connecting point.<sup>129</sup> An in-line or in-tank transfer is rather similar to transfers of grains or metals. It should be noted that the Brent Crude Oil futures traded in the ICE Futures are in principle not deliverable, owing to the oil's offshore production and difficulties in designing a contract specification in line with the size of an oil tanker.<sup>130</sup>

Electricity too is a special kind of commodity because it cannot really be defined as "property". The transmission of electricity is similar to that of oil or gas but is greatly limited by facilities. For example, COB electricity futures contracts could be delivered only at the point(s) of interconnection on the boundary line between the states of California and Oregon.<sup>131</sup>

Fourthly, the place of delivery, which depends on the product and the exchange, must be determined. For some products, delivery location is limited by the exchange itself. For example, delivery of CBOT corn futures is limited to certain places near Chicago or in the Midwest.<sup>132</sup> For other products, the delivery point might be limited by the nature of the underlying asset. For example, WTI crude oil can only be produced in the Southern US, and delivery points are limited to places within the State of Texas.<sup>133</sup> LIFFE feed wheat futures require the origin of the wheat to be the EU and the list of grain storekeepers to date does not include any outside the UK.<sup>134</sup>

In contrast, the delivery of some commodities is not restricted by geographical boundaries. For example, NYMEX gold futures and LME silver futures in the LME allow gold and silver bars from anywhere in the world. By specifying the grades and the qualities of the underlying metals, and by supervising qualified

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<sup>128</sup> NYMEX Rule 505.14.

<sup>129</sup> NYMEX Rule 505.14 (WTI Crude oil) and Rule 220.10 (Natural Gas Futures).

<sup>130</sup> Oil Trading Manual, section 8.1, p5 (Woodhead, 1995).

<sup>131</sup> NYMEX Rules 400.02 & 400.12. "COB" stands for "California Oregon Border".

<sup>132</sup> CBOT Rule C1041.01.

<sup>133</sup> NYMEX Rule 505.14.

<sup>134</sup> The list can be found in

<[http://www.euronext.com/editorial/wide/0,5371,1732\\_203152161,00.html](http://www.euronext.com/editorial/wide/0,5371,1732_203152161,00.html)> (visited on 4 December 2006).



warehouses or depositories, the exchange and the clearing house can confirm that the quality and quantity of the underlying metals satisfy the specifications of the contract (any deviation from which might endanger the credibility of trading). Indeed, warehouses approved by the LME are scattered around the world.<sup>135</sup> The same is true of a number of agricultural products. For example, the warehouse keepers qualified by the LIFFE for coffee and cocoa are located in many European cities outside the UK, and delivery may take place in other countries.<sup>136</sup>

Lastly, if a futures contract ends in physical delivery, it should be accessible by sale of goods laws. Can a futures contract therefore be called a “contract of sale” in the first instance?<sup>137</sup> Most participants in the commodities futures market do not intend to make or take delivery; thus it is difficult to say the seller really “agrees to transfer” the commodities. On the other hand, if the contract requires an open contract to make delivery, the “contract” itself still requires the party to deliver unless the contract is liquidated before the end of trading. However, since most futures contracts are liquidated before delivery, and as most traders have no intention to make or take delivery, it might not be appropriate to define all contracts as “contracts of sale”.<sup>138</sup>

A more practical question is: when does a contract of sale turn into a “sale”?<sup>139</sup> The answer to this question depends on the exact wording of exchange and clearing rules. A sale should be deemed to take place when goods are transferred from the seller to the buyer. There is no sale if the futures position is cleared before delivery. Eventually, as mentioned above, commodities may be transferred on paper by transferring warehouse receipts or similar documents, or when the title is transferred. Thus, the “sale” should be said to have taken place

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<sup>135</sup> The list can be found in < [http://www.lme.com/what\\_warehouses\\_approved.asp](http://www.lme.com/what_warehouses_approved.asp) > (visited on 28 November 2006).

<sup>136</sup> The list can be found in < [http://www.euronext.com/editorial/wide/0,5371,1732\\_203152161,00.html](http://www.euronext.com/editorial/wide/0,5371,1732_203152161,00.html) > (visited on 4 December 2006).

<sup>137</sup> Sale of Goods Act 1979, section 2(1). In the US, see UCC Article 2-106(1).

<sup>138</sup> Cf. *CR Sugar Trading Ltd v China National Sugar and Alcohol Group Corp* [2003] 1 Lloyd’s Rep 279, where two exercised put options were held to be for investment purposes. See supra 3.1.1 for further details of this case.

<sup>139</sup> Sale of Goods Act 1979, section 2(4). In the US, see UCC Article 2-106(1).

when the document is delivered. On the other hand, who are the parties to the “sale” contract? If the documents are delivered from the seller to the clearing house, which in turn assigns the documents to the buyer, the sale seems to take place between the seller and the clearing house and between the clearing house and the buyer, rather than directly between the buyer and the seller.

### **3.2.3.3.2 Exchange-for-Physical**

Apart from standard delivery, so-called “exchange for physical” (EFP)<sup>140</sup> is becoming more popular in cases where the trader does not want to take delivery following standard procedures. An EFP is the exchange of a futures position for physical delivery. For example, the buyer has an open long futures contract, and the seller has a short position as well as physical goods. Under an EFP agreement, the buyer will take delivery directly from the seller and at the same time transfer his open long position to the seller. The newly acquired long position will cancel out the short position held by the seller, and the seller will profit (or lose) from the price difference between the long and short positions. On the other hand, the buyer receives the delivery of the commodities and clears his open position through the EFP. Depending on the relevant futures positions a party holds, an EFP can also be used to increase an investor’s open interests.<sup>141</sup> Because the settlement price for the EFP and the volume of exchange are negotiated by the two parties, the EFP can give both a vehicle to adjust their levels of exposure in the spot market and futures market trading.<sup>142</sup>

EFP transactions give traders flexibility as they can deviate from the specifications of a futures contract when performing an EFP.<sup>143</sup> The delivered commodities need not be of the same type, of the same quality, or of the same quantity as the futures contracts. Thus, two investors who hold futures positions in May wheat futures delivered in Chicago may conduct an EFP transaction to

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<sup>140</sup> Also called “exchange against actuals”, “exchange of spot”, and “exchange versus cash”.

<sup>141</sup> See <<http://www.cme.com/trading/prd/ag/res/exchange3329.html>> (visited on 17 Oct 2006).

<sup>142</sup> *Id.* The Chicago Mercantile Exchange provides on its website some examples of how the EFP works. See <<http://www.cme.com/trading/prd/ag/res/efpexample3334.html>> (visited on 17 Oct 2006).

<sup>143</sup> See *supra* note 141. See also Das, *Derivative Products & Pricing*, at 46-47 (3rd ed., rev edn., John Wiley & Sons, 2006).

make a contract to deliver wheat in Kansas City or to exchange for cotton delivery. This flexibility may partly explain why in many markets the EFP is more popular than standard delivery.<sup>144</sup>

However, because the EFP is an off-exchange transaction between two or more parties concerning futures positions made in the exchange/clearing house, exchanges and clearing houses all want to keep EFP transactions under control, and EFP operations also require settlement in the clearing system.<sup>145</sup> Thus, all exchanges and clearing houses require EFP parties to register with the clearing house and keep the transaction on record. For example, at the CBOT a seller of the spot commodities must be the buyer of futures positions in an EFP.<sup>146</sup> The NYMEX also provide detailed rules on the timing for registration of an EFP deal, on who can enter into an EFP, and on relevant procedures.<sup>147</sup> The Eurex even provides OTC trading facilities for EFPs.<sup>148</sup>

Since an EFP is done off exchange and a futures position needs to be cleared through a clearing member, the documentation for an EFP must be carefully designed to ensure the cooperation of all concerned parties and to determine the obligation existing between them. The standard form published by the London-based Futures and Options Association (FOA) thus adopts a two-part structure: 1) the transaction between a trader and a dealer on behalf of its customer (trader version); and 2) the transaction between the dealer and the customer with both acting as principal (customer version).<sup>149</sup> Both versions specify that the customer's clearing broker is a necessary party to the agreement.

The last question about the EFP we will consider is at what time a sale occurs. Like standard delivery, a sale happens when commodities are delivered from commodity seller to commodity buyer. However, whether the EFP can be

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<sup>144</sup> See Oil Trading Manual, *supra* note 130, at section 8.3.

<sup>145</sup> See LIFFE Trading Procedures, section 4.4; CBOT Rule 331.06 – 331.08; CME Rule 538; NYMEX Rule 6.21.

<sup>146</sup> CBOT Rule 331.08.

<sup>147</sup> For example, NYMEX Rule 6.21.

<sup>148</sup> See <[http://www.eurexchange.com/trading/market\\_model/wholesale\\_en.html](http://www.eurexchange.com/trading/market_model/wholesale_en.html)> (visited on 4 December 2006).

<sup>149</sup> FOA's EFP Transactions Agreement can be downloaded from <<http://www.foa.co.uk/documentation/EFP/index.jsp>> (visited on 17 Oct 2006).

treated as a contract of sale is another matter. Apparently, an EFP is not a contract to transfer goods for monetary consideration. The consideration is a “contract” (a futures position). Whatever the nature of the EFP agreement, a sale will eventually take place when the commodity seller transfers the goods to the commodity buyer.<sup>150</sup>

A variation of the EFP is the “exchange-for-swap” (EFS). An EFS agreement is an exchange of futures positions for a swap contract (instead of a sale).<sup>151</sup> It is usually used where the futures and the swap are to a certain degree correlated such that the futures positions can become a hedge against exposure in a swap agreement (e.g. German bund futures in exchange for interest rate swap).<sup>152</sup> Although an EFS can well be used for commodity swaps, it is necessary to understand that an EFS does not lead to physical delivery as an EFP does.

### 3.2.4 Lessons from Exchange Trading

In the above discussion, it was found that in the LIFFE/LCH and CBOT/CME structures, exchange contracts—agreements between traders in the trading pit or matched by an electronic system—remain the basis of futures trading. The contractual structure plays an important role in making the futures market as it is seen today.

Among all, exchange trading has certain key features. First, an exchange contract is highly standardised such that price is the only element subject to negotiation. Secondly, through a series of novation, exchange contracts are transformed into contracts between clearing houses and clearing members. Thirdly, with the help of the mark-to-market strategy and the use of margin, each exchange contract should eventually have the same price term at the end of a trading day so that opposite contractual positions can cancel each other out smoothly.

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<sup>150</sup> Thus, if an EFP agreement is eventually in default, the sale of goods law applies. *See Apex Oil Co v Belcher Co of New York, Inc.*, 855 F 2d 997 (1988).

<sup>151</sup> The NYMEX also has special rules for EFS transactions. *See* NYMEX Rule 6.21A.

<sup>152</sup> *See* <[http://www.eurexchange.com/trading/market\\_model/wholesale/efs\\_en.html](http://www.eurexchange.com/trading/market_model/wholesale/efs_en.html)> (visited on 4 December 2006).

Fourthly, the “contract” itself virtually becomes the basic unit of trading in a futures exchange. Although the exchange contract may still appear in the form of a proper contract, it no longer dominates the managing of risk allocation and the rights and obligations of parties. Instead, rights and obligations regarding payment, delivery and other matters devolve to exchange/clearing membership agreements and rules. Lastly, even though the futures market is now largely for notional trading, we found that the futures market is still capable of making delivery, should an exchange contract so require.

Given the high daily trading volume in major commodity exchanges around the world, it is intriguing how rarely a futures contract incites legal disputes. With careful management, major futures exchanges have seldom run into serious troubles during the past half century. However, the futures market does have certain legal implications that cannot be ignored.

First, the futures market serves an important price discovery function. Since all the terms of a futures contract except prices are standardised, the futures market has effectively become a place for discovering market prices. On the one hand, futures prices provide an indication of possible future prices to those who might need to know so that they can plan necessary risk management transactions in advance. On the other hand, futures prices are frequently used as an important price reference for spot market or over-the-counter transactions as the futures market provides a relatively open and transparent platform for market participants from different levels to compete for better prices.<sup>153</sup>

Thus, the integrity of this price discovery function is an essential issue. The abuse of the futures market clearly raises regulatory concerns; and such abuse may occur in several ways. Market manipulation or speculation might distort market prices so as to send wrong signals to market participants. The wrong market prices might influence not only market players but also the welfare of consumers, whose lives depend on the price level of major commodities (such as

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<sup>153</sup> A trader’s constant arbitraging between the spot market and the futures market and his use of all available information to trade in the futures market would move spot and futures prices in a similar direction such that the futures market becomes an important price reference to the relevant spot market trading. See, Romano, *supra* note 2, at 13-15.

oil). In addition, over-speculation in the futures market has plagued the US market ever since the creation of the CBOT in the mid-19th century.<sup>154</sup> Even with the margin system and the intervention of clearing houses, a speculator still faces full financial obligation to perform each exchange contract that is not liquidated before the end of trading. This is where large default may occur and the credibility of clearing houses may be challenged.

Secondly, when defaults have occurred, they often happened in a spectacular fashion and involved a significant degree of market manipulation. One such story is that of the infamous Maine potato default in 1976, the result of a large-scale market manipulation scheme. According to *Leist v Simplot*<sup>155</sup>, the scandal involved two groups of traders. The first group (short group), led by Simplot (S), attempted to depress the potato market by selling a lot of potato futures (so that they could buy potatoes at a lower price and resell them later at a higher price). Discovering S's scheme, the second group (long group) not only bought a lot of potato futures but also tried to control potato supply in the spot market. Neither group would give in. It was reported that

“[a]t the end of trading on May 7 [1976], the short conspirators controlled 1893 open short positions. The long conspirators controlled 911 open long positions. There [were] usually only approximately 200 open contracts at the end of trading on the May potato future.”<sup>156</sup>

Since the long group virtually controlled most of the potato supply available for delivery, the outcome was the

“much publicized default in May 1976 of Maine potato futures contracts, when the sellers of almost 1,000 contracts failed to deliver approximately 50,000,000 pounds of potatoes, resulting in the largest default in the history of commodities futures trading in this country.”<sup>157</sup>

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<sup>154</sup> See generally, Markham, *The History of Commodity Futures Trading and Its Regulation* (Praeger, 1987).

<sup>155</sup> 638 F 2d 283 (1980).

<sup>156</sup> *Id.*, at 290.

<sup>157</sup> *National Super Spuds, Inc v New York Mercantile Exchange*, 470 F Supp 1256, at 1258 (1979).

Mr. Leist, the plaintiff in the case, was an unfortunate trader, who was anticipating an upturn in the potato market but was caught in the duel between the short and long groups. Naturally, lawsuits followed. Leist and other people who suffered a similar fate brought actions to claim damages against the New York Mercantile Exchange, brokers, and other people who had initiated the manipulative schemes based on the Commodity Exchange Act (CEA). The key issue was whether the violation of the CEA (as a federal statute) might imply a private cause of action,<sup>158</sup> an issue which will not be explored here since it is outside the scope of this thesis. Fortunately for Leist, the majority of the Second Circuit court held for him.

We could learn from the Maine potato default the lesson that the exchange market is not free from default and that market manipulation is a concern to both market participants and regulators. Apart from typical squeezing or cornering of the market,<sup>159</sup> one might dispatch false reports to the general public, hoping that such false information might lead market prices in one's favour.<sup>160</sup> In addition, arguably one might also use inside knowledge on a certain matter to gain profits or to avoid losses before that piece of information becomes available to the general public. Manipulation in the commodities market is an area of its own and this thesis will not enter into the details of the meaning of manipulation and how to address manipulation, but certain issues of insider dealing will be discussed in Chapter 5 in relation to information disclosure for risk trading.<sup>161</sup>

Thirdly, there are concerns about the capability of exchanges and clearing houses to control over-speculation and market manipulation. In light of the trading and

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<sup>158</sup> See, *National Super Spuds, Inc v New York Mercantile Exchange*, 470 F Supp 1256, at 1258 (1979); *National Super Spuds, Inc v New York Mercantile Exchange*, 660 F 2d 9 (1981); *Leist v Simplot*, 638 F 2d 283 (1980).

<sup>159</sup> See Perdue, "Manipulation of Futures Markets: Redefining the Offense" (1987) 56 Fordham L Rev 345; Freidman, "Stalking the Squeeze: Understanding Commodities Market Manipulation" (1990) 89 Mich L Rev 30; Bianco, "The Mechanics of Futures Trading: Speculation and Manipulation" (1977) 6 Hofstra L Rev 27. Squeezing or cornering the market, like the scheme in the Maine potato default, might also raise some competition law arguments, as the plaintiffs did in *National Super Spuds, Inc v New York Mercantile Exchange*, 470 F Supp 1256 (1979).

<sup>160</sup> See for example, *CFTC v Foley*, 2006 US Dist LEXIS 70437; *CFTC v Atha*, 420 F Supp 2d 1373 (2006); *CFTC v Erskine*, 2006 US Dist LEXIS 26319.

<sup>161</sup> The issue of insider dealing in commodity trading will be discussed in *infra* 5.5.2.2.

clearing structure discussed above, exchanges and clearing houses are obviously the focal point for maintaining the trading market. Whether an exchange or a clearing house is capable of supervising the trading market is apparently an issue of concern for regulators. On the other hand, when an exchange does intervene to stop a large default or a manipulative scheme, the exchange might still get into legal troubles.<sup>162</sup> Whether a financial regulator should intervene more or rely on the self-regulatory powers of exchanges and clearing houses is a topic that will not be elaborated upon here.<sup>163</sup>

Fourthly, a more serious concern arises when a relevant party in futures trading becomes insolvent. Although the margin system and the financial requirements for membership may reduce the chance of going insolvent due to trade losses in the futures market, it is not impossible that a clearing member or an exchange member become insolvent because of his other business activities. Regulators and clearing houses might worry about the contagious effect of financial trouble. The contractual ties between market participants might turn insolvency into a snowball. To prevent such situations, all exchanges and clearing houses have rules to deal with the bankruptcy or insolvency of their members.<sup>164</sup> A clearing house may also impose rules to limit its liability and prevent unexpected losses.<sup>165</sup> It should be noted that in some countries there is a special insolvency procedure for exchange trading. For example, in the UK, Part VII of the Companies Act 1989 provides special rules to safeguard the operation of certain financial markets with respect to the insolvency of members; the US Bankruptcy Code does the same.<sup>166</sup> However, there is still some danger that a clearing

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<sup>162</sup> For example, *see Zimmerman v Chicago Board of Trade*, 360 F 3d 612 (2004). In this case, a trader unsuccessfully challenged CBOT's order to stop trading because of concerns on market manipulation.

<sup>163</sup> *See* Zuffrey and Tschanz-Norton, *Regulation of Trading Systems on Financial Markets* (Kluwer Law International, 1997); Lee, *What Is An Exchange? The Automation, Management, and Regulation of Financial Markets* (OUP, 2000); Pirrong, "The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation" (1995) 38 J Law & Econ 141; Keaveny, "In Defense of Market Self-Regulation: An Analysis of the History of Futures Regulation and the Trend toward Demutualization" (2005) 70 Brooklyn L Rev 1419.

<sup>164</sup> For example, *see* CBOT Rules 270.00 *et seq.*; NYMEX Rules 10.

<sup>165</sup> For example, *see* LCH Regulation 22.

<sup>166</sup> 11 USCA 555 & 556.



house itself may become insolvent. This may be why clearing houses are supervised by financial regulators.

Fifthly, futures exchanges and clearing houses have less control over market participants who are not members of the exchange but who trade through a broker with membership in the exchange. This raises further legal implications about legal relationship between brokers and their clients.

Lastly and most closely related to the discussion that will occupy the rest of this chapter, there are certain legal issues involving the use of futures prices or exchange-like features in spot market transactions. Given modern futures regulations, the use of futures techniques in spot market trades might invite regulatory intervention in the name of futures regulation (see 3.1 above). This would then lead to the question of why off-exchange transactions are regulated as “futures”, a question that will be the theme of the next part of this chapter.

### **3.3 Off-exchange Commodity Contracts**

The above discussion illustrated how a futures exchange facilitates trading and how it becomes a powerful playground for hedging and speculating price risk. Then, it may be wondered whether it is possible to apply the features of exchange trading to an off-exchange transaction. Contractual parties might prefer to hedge with a spot contract instead of using the futures market. Nevertheless, certain trade practices and contractual terms also increase the chance that a spot market contract would be considered a “futures” contract in law. The following sections will examine case laws relating to certain types of contract or clauses that help to redress price risk and liquidity risk in order to see how English and American judges perceive these off-exchange commodity contracts and the legal meaning of “futures”.

### 3.3.1 Hedge-to-arrive Contracts

So-called “hedge-to-arrive” contracts (HTA) represent an interesting angle from which to observe how an off-exchange trading contract might look like an exchange-traded futures contract. Grain farmers have a strong interest in managing the fluctuation of grain prices, so several contractual arrangements have been developed in the grain market in order to reduce risks from seasonal variations in commodity prices.<sup>167</sup> HTAs might be traced back to a popular type of forward contract in the 19th century called “to arrive” contracts, which were contracts to purchase goods upon arrival.<sup>168</sup> The trading of the “to arrive” contract later became more standardised and gave birth to the first organised exchange in the world, the Chicago Board of Trade.<sup>169</sup>

In the words of a judge, an HTA contract is a transaction by which

“a grain producer agrees to deliver at an unspecified time a predetermined quantity and grade of grain. The price of the grain is determined by reference to a futures contract price established by the Chicago Board of Trade (CBOT), plus or minus a variable component referred to as the “basis”. Basis is the difference between the price of the designated futures contract and the cash price for that commodity.... The basis remains unfixed, or ‘floating’, until the farmer elects to fix the basis at which point the grain will be delivered. Under an HTA, a farmer has at least two sale options on his crop: he can deliver grain under the HTA, or he can defer delivery on (i.e. ‘roll’) the contract if he thinks he can get a better price in the cash-grain market.”<sup>170</sup>

The above definition covers several types of HTA transactions. The basic type (or so-called “non-roll”) is where the contract price is determined by the futures

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<sup>167</sup> See 1996 CFTC Ltr 145, at 5-6.

<sup>168</sup> Romano, *supra* note 2, at 7. The “to arrive” contract originated from Europe. See also Morgan, *Merchants of Grain*, at 59 (Penguin, 1980); Markham, *The History of Commodity Futures Trading and Its Regulation*, at 3 (Praeger, 1987); Clark, “Genealogy and Genetics of ‘Contract of Sale of a Commodity for Future Delivery’ in the Commodity Exchange Act Symposium: Regulation of Commodity Futures Trading” (1978) 27 Emory LJ 1175, at 1180.

<sup>169</sup> See generally, *Commodity Trading Manual*, *supra* note 46, at 4 *et seq.*; Markham, *id.*, at 3-4. See also <<http://www.cbot.com/cbot/pub/page/0,3181,942,00.html>> (visited on 18 Oct 2006).

<sup>170</sup> *Asa-Brandt, Inc v ADM Investor Services, Inc*, 344 F 3d 738, at 741-742 (2003), citing *Grain Land Coop v Kar Kim Farms, Inc*, 199 F 3d 983, at 987 (1999).

market plus or minus the “basis” and with a fixed future delivery date.<sup>171</sup> The futures price is fixed at first, but the basis can be determined later. A contrary type of HTA is called a “basis contract”, in which the basis is fixed at the beginning but the futures price level can be chosen later.

Subject to the contract, the time that determines the contract price in an HTA is usually up to the seller-farmer. Thus, the seller should investigate and predict the movements of the spot market prices and the futures market so as to maximise his profits. The buyer (usually grain elevators) then purchases futures contracts in the CBOT. Therefore, the price mechanism in a basic HTA is simply a method for setting the contract price.<sup>172</sup> In effect, it defers the determination of the price to a later stage.

What makes HTAs more intriguing is the “rolling” clause.<sup>173</sup> In the case of some HTAs, the contracts provide that the seller may defer delivery to a later date if the price in the cash market on the original delivery date is higher than the HTA contract price. This means that the seller can avoid virtual losses (from an HTA deal) by selling the grain in the spot market and delaying the delivery. There is no problem with this if the seller-farmer has enough grain to make two deliveries. In practice, it is very uncertain.

To understand the problem, one should bear in mind that grain is a seasonal product. Subject to contractual terms, rolling can defer delivery to later in the same year (for example, from August to September), to the next production year (e.g. from August 2009 to August 2010), or even to several years later. The farmer might not have enough grain to make delivery either later in the same year or in the next year, in which case he might have to buy grain on the cash market to meet his delivery obligations. Then, the farmer is again exposed to price risk in the delivery stage. Thus, an HTA is rather a speculative vehicle for farmers.<sup>174</sup> Since a buyer-elevator usually uses the CBOT to hedge against risks from HTAs,

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<sup>171</sup> The meaning of “basis” has been introduced in *supra* 2.2.2.2.

<sup>172</sup> Iavarone, “Understanding the Hedge-to-Arrive Controversy” (1997) 2 Drake J Agric L 371, at 374.

<sup>173</sup> HTAs with a rolling clause are sometimes called “flex”. See *Grain Land Coop v Kar Kim Farm, Inc*, 199 F 3d 983, at 987 (1999).

<sup>174</sup> See *general*, Iavarone, *supra* note 172.

the rolling process means that grain elevators must close their existing open interests and acquire new hedges in the futures market.

Problems arose quickly after the historically high price in 1995, which led farmers to roll over their HTAs.<sup>175</sup> While farmers seemed to gain from the high spot prices, grain elevators suffered huge losses because they had to liquidate their short futures positions in the CBOT at very disadvantageous prices, which had a huge impact on the agricultural economy.<sup>176</sup> Disputes soon broke out and one important legal issue was whether HTAs were regulated “futures contracts”.<sup>177</sup>

If we examine carefully the price clause for an HTA, we may find that the HTA is actually similar to the long or short hedge strategy and the “basis” trading introduced in section 2.2.2.2 above. Under a basic HTA, a farmer uses the futures price in the CBOT as a benchmark price and may choose the “basis” later. This may lead to the same result as launching a short hedge strategy using the CBOT market, except that with an HTA the farmer does not need to set foot on the exchange floor. The rigidity of specifications for futures contracts at the CBOT might make exchange trading less flexible and more costly for grain farmers. The HTAs provide an alternative for farmers to hedge against price fluctuation by reference to CBOT prices but without actually trading at the exchange. While buyer-elevators purchase futures contracts in the futures market to hedge their exposure from HTA transactions, the buyer-elevators are in fact the farmer’s agents, hedging on his behalf in the futures market.<sup>178</sup> Therefore, some argue that HTAs are effectively a vehicle for speculation rather than real sales.<sup>179</sup>

The rolling function and price determination regime makes HTAs similar to off-exchange futures contracts; thus there have been disputes as to whether these

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<sup>175</sup> *Grain Land Coop*, *supra* note 173, at 987-988.

<sup>176</sup> See generally, Cole, “Hedge-to-arrive Contracts: the Second Chapter of the Farm Crisis” 1 Drake J Agric L 243 (1996).

<sup>177</sup> In 1996, upon inquiries by market participants, the CFTC issued a letter explaining the CFTC’s opinion on the matter. However, the CFTC was reluctant to make a final decision and preferred to decide the issue on a case-by-case basis. See 1996 CFTC Ltr 145.

<sup>178</sup> See Iavarone, *supra* note 172.

<sup>179</sup> Id.

contracts are illegal and thus void. A series of HTA cases arose in the American Midwest, and the courts generally recognised HTAs as "cash forward contracts" rather than futures contracts.<sup>180</sup> The basic theory is that both parties have the intention of making delivery when the contract is made.

In *Nagel v ADM Investor Services, Inc.*,<sup>181</sup> Judge Posner adopted the "totality of the circumstances" test first proposed in *Co Petro* (introduced in 3.1.2.2 above), and proposed a few factors for consideration:

- "(1) The contract specifies idiosyncratic terms regarding place of delivery, quantity, or other terms, and so is not fungible with other contracts for the sale of the commodity, as securities are fungible....
- (2) The contract is between industry participants, such as farmers and grain merchants, rather than arbitrageurs and other speculators who are interested in transacting in contracts rather than in the actual commodities.
- (3) Delivery cannot be deferred forever, because the contract requires the farmer to pay an additional charge every time he rolls the hedge."<sup>182</sup>

Of course, the application of the above test varies contract by contract, and thus it would be difficult to conclude that all HTAs are or are not regulated futures contracts without examining carefully the contractual terms of each transaction.<sup>183</sup> Assuming a fixed delivery date and obligation, a basic HTA seems no different from other contract for sale of grain except that the price term is more flexible.

In contrast, the rolling clause adds some liquidity to the basic HTA, as a farmer might sell his grain in the cash market if the spot price is more favourable. The US court seemed ready to conclude that rolling HTAs fell within the cash forward exception as long as delivery obligation might not be deferred forever.<sup>184</sup> On the other hand, cash forwards or not, HTAs still use complicated financing

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<sup>180</sup> See *Asa-Brandt, Inc v ADM Investor Services, Inc.*, 344 F 3d 738 (2003); *Nagel v ADM Investor Services, Inc.*, 217 F 3d 436 (2000); *Lachmund v ADM Investor Service, Inc.*, 191 F 3d 777 (1999); *Grain Land Coop v Kar Kim Farm*, 199 F 3d 983 (1999); *Andersons, Inc v Horton Farms, Inc.*, 166 F 3d 308 (1998); *Oeltjenbrun v CSA Investor Inc.*, 3 F Supp 2d 1024 (1998).

<sup>181</sup> 217 F 3d 436 (2000).

<sup>182</sup> *Id.*, at 441.

<sup>183</sup> *Id.*

<sup>184</sup> In addition, it cannot be ignored that HTAs were largely used by farmers and grain merchants rather than by speculators as in *Co Petro*.

techniques, and there is a question of whether farmers understand the nature of the market and the potential impact of signing an HTA agreement (particularly a rolling one). This led to further disputes regarding the liability of a financing company when promoting an HTA to farmers or grain merchants.<sup>185</sup>

In the end, the possible outcome of applying UK law to the HTA cases should be considered. First, HTAs, basic or rolling, should satisfy the definition of a futures contract with delivery to be made at a future date and a predetermined method to decide sale prices by reference to the exchange market.<sup>186</sup> The next issue is whether HTAs are for commercial purposes or for investment purposes. HTAs cannot be regarded as being for investment purposes because they are not traded on organised exchanges.<sup>187</sup> Nor could one presume that they are for commercial purposes, as delivery would most likely not be made within seven days. Unlike *CR Sugar*,<sup>188</sup> farmers who enter into HTAs are actually grain producers, and grain merchants and millers who generally use grain for their own business. In addition, HTAs do require delivery, even rolling HTAs. Therefore, we may conclude that HTAs are more likely to be seen as futures contracts for commercial purposes and might not be regulated under the FSMA 2000.

### 3.3.2 Chain of Sales: Circle or Book-out Clauses

Without the establishment of a clearing house, it is still possible for merchants to clear their transaction based on bilateral agreements. In practice, it is not uncommon that a seller in a transaction becomes a buyer of the same amount of the same goods in another deal, possibly leading to a chain of sales. This situation is best explained by *Tradax Export SA v Carapelli SpA*.<sup>189</sup> In this case, the following circle was found:

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<sup>185</sup> See *Asa-Brandt, Inc v ADM Investor Services, Inc*, 344 F 3d 738 (2003).

<sup>186</sup> RAO 2001, article 84(1) & (8).

<sup>187</sup> *Id.*, article 84(3).

<sup>188</sup> [2003] 1 Lloyd's Rep 279.

<sup>189</sup> [1977] 2 Lloyd's Rep 157.

Seller	Buyer	Contract price
Rocco	Siat	\$163 per m.t.
Siat	Carapelli	\$172 per m.t.
Carapelli	Tradax	\$235 per m.t.
Tradax	Rocco	\$140 per m.t.

Some standard forms contain a clause to deal with situations like the above. A “circle clause” can be found on the GAFTA forms and FOSFA forms concerning grain sales. According to this clause,

“[w]here Sellers re-purchase from their Buyers or from any subsequent Buyer the same goods or part thereof, a circle shall be considered to exist as regards the particular goods so re-purchased. ... [In this situation,] “if the goods are not appropriated, or, having been appropriated documents are not presented, invoices based on the mean contract quantity shall be settled by all Buyers and their Sellers in the circle by payment by all Buyers to their Sellers of the excess of the Sellers' invoice amount over the lowest invoice amount in the circle.”<sup>190</sup>

In *Tradax*, a circle was discovered and Tradax sent telex messages to the other parties in the circle to propose settlement. In this circle, the lowest invoice price was \$140 per m.t. (from Tradax to Rocco). Therefore, the result of the circle was:

Rocco to Tradax	\$0 per m.t.
Tradax to Carapelli	\$95 per m.t. (\$235–\$140)
Carapelli to Siat	\$32 per m.t. (\$172–\$140)
Siat to Rocco	\$23 per m.t. (\$163–\$140)

The net payment was:

<sup>190</sup> For example, GAFTA Contract No.100 (Contract for Shipment of feeding stuffs in Bulk Tale Quale–CIF Terms), clause 29; FOSFA Contract No 53 (Contract for Vegetable and Marine Oil (in bulk) FOB Terms), clause 25.

Tradax pays to Siat \$9 per m.t.	$\$172 - \$163 = \$32 - \$23$
Tradax pays to Carapelli \$63 per m.t.	$\$235 - \$172 = \$95 - \$32$
Tradax pays to Rocco \$23 per m.t.	$\$163 - \$140$
Net loss for Tradax: \$95 (\$235-\$140)	

In *Tradax*, the issue was whether an embargo, imposed by the US government after the circle was found, would influence the amount that Tradax had to pay. The court held for Tradax to reduce payment owing to the embargo. The rest of the case and details of the judgement have no bearing on this thesis and will therefore not be addressed here.

Similar terms appear in the 15-day Brent crude oil market.<sup>191</sup> The 15-day Brent crude oil contract usually contains a “book-out” provision which works like the circle clause mentioned above. The difference in the 15-day Brent market is that the relevant parties have to reach a “book-out” agreement to determine a “base price” as the basis to calculate their respective payment obligations among parties.<sup>192</sup> As a judge observed, “[o]n the choice of a base price depended not only the amount payable on a book-out under each of the contracts in the [chain], but also whether it was the buyer or the seller who would in fact make the appropriate payment.”<sup>193</sup>

Therefore, one question arises: if all parties have agreed on every important term except the base price, and all parties orally agree to solve the circle without any physical delivery within the circle, can the court determine the “base price” for the parties? In *Voest Alpine Intertrading GmbH v Chevron International Oil Co*

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<sup>191</sup> The off-exchange Brent crude oil contract can be divided into two categories: the “dated” contract and the “15-day” contract. In the dated contract, the delivery date is specified in the contract. In contrast, the “15-day” contract has no specific delivery date but allows the seller to give notice to nominate the delivery date 15 days prior to the intended delivery day (thereby giving rise to the name “15-day Brent”). See Oil Trading Manual, *supra* note 130, section 4.2, p 2-3; CFTC Statutory Interpretation, 55 Fed Reg 39188 (1990).

<sup>192</sup> Oil Trading Manual, *id.*, at section 12.3.

<sup>193</sup> *Voest Alpine Intertrading GmbH v Chevron International Oil Co Ltd* [1987] 2 Lloyd’s Rep 547, at 558.



*Ltd*<sup>194</sup>, the parties agreed upon a number of important terms except the base price for the book-out agreement. The defendant claimed that the original 15-day contracts had been reinstated after failure to reach a book-out agreement. In contrast, the claimant claimed that an agreement had been reached and the minimum price in the circle should be employed to calculate the settlement payment. The court treated the oral agreement as incomplete, and the court implied a reasonable price as the base price by interpreting the intentions of the parties.<sup>195</sup> The court also rejected the defendant's claim that "the original contracts were merely suspended, with the consequence that they would, in default of an agreement as to a base price, be revived in a subsequent month".<sup>196</sup>

The weakness of using a contractual term to deal with a multi-party situation may be seen in both *Tradax* and *Voest*. Settlement of multi-party obligations requires at least one party to initiate the process (like *Tradax*'s telex) and relies on the cooperation of the others. The crucial question is whether a new settlement agreement must be reached so as to effectuate the resolution (as in the 15-day Brent market) or whether the notice alone may effectuate the settlement. If a new agreement is not required, what happens if one party in the circle fails to cooperate? Can other parties sue him for cooperation? It may be argued that a multi-party contract is formed among relevant parties in the case of the circle clause under the GAFTA form, given that the circle clause also requires buyers and sellers to give every assistance to ascertain the circle. However, if no such multi-party contract is found, the enforceability and operation of the clause might be limited by the doctrine of privity, which would be problematic if the party failing to cooperate were also the one obliged by the circle clause to make payment.

If a new agreement is required, the problem becomes one of the formation of contract. If this approach is followed, what are the essential elements of this new agreement? It is apparent that the settlement price is the key factor (like the base price in *Voest*). However, in *Voest* the court held that a consensus to

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<sup>194</sup> [1987] 2 Lloyd's Rep 547.

<sup>195</sup> *Id.*, at 558-559 & 562.

<sup>196</sup> *Id.*, at 560.

resolve the existing circle is enough to form a contract. The GAFTA form makes it easier by using the lowest contractual price in the circle as the benchmark price on the basis of which to calculate related payments. The circle clause also covers situations where one party becomes insolvent or is liquidated.

Nevertheless, even if the settlement or book-out looks efficient to the relevant parties, it is not always desirable. For example, a player in the Brent market who intends to arbitrage between the dated contracts and 15-day contracts might find his scheme breaks down if the 15-day contract is booked out.<sup>197</sup> This may explain why similar clauses do not exist in many other trade rules or standard forms.

With the help of the book-out clauses, the 15-day market provides an example of how spot market trades can evolve into an exchange-like contract market and become a harbour for hedging or speculation. In a market with a limited number of participants, it may not be difficult to spot a chain of sales and so to initiate a book-out. Thus, the result of a book-out or circle clause might turn an ordinary sale into an exchange-like notional transaction, which enhances the chance for treating the contract as a regulated futures contract.

In *Transnor (Bermuda), Ltd v BP North America Petroleum, Inc.*,<sup>198</sup> Transnor purchased some North Sea crude oil from BP on the basis of a 15-day Brent contract.<sup>199</sup> However, after realising that the oil price dropped after the contract was made, Transnor refused to take delivery and subsequently sued BP for violation of US anti-trust law by conspiring with other companies to depress oil price and of the CEA by manipulating the market. The anti-trust claim is not our concern here, so we will focus on the CEA claim below.

Transnor's CEA action raised a question whether a 15-day Brent contract (with a book-out clause) was a regulated futures contract under US law. Naturally, BP argued that the 15-day Brent contract was a "cash forward", rather than a "futures" contract. The District Court judge acknowledged that

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<sup>197</sup> Oil Trading Manual, *supra* note 130, section 12.3, pp. 5–6.

<sup>198</sup> 738 F Supp 1472 (1990).

<sup>199</sup> See *supra* note 191 for explanation of the two popular types of Brent contracts.

“15-day Brent contracts may represent binding commitments to buy or sell physical oil. The real question, however, is whether the transactions are more like bargains for the purchase and sale of crude oil than speculative transactions tacitly expected to end by means other than delivery.”<sup>200</sup>

Applying the *Co Petro* decision,<sup>201</sup> the court drew the conclusion that “[t]he high levels of speculation and performance without delivery, as well as the relatively standardized contracts, distinguish the 15-day Brent transactions from the forward contracts contemplated by the drafters of the [CEA].”<sup>202</sup>

In addition, the judge found that “‘only a minority of transactions in the Brent market result in delivery.’ ...The customary use of offsetting and booking out strongly suggests that physical delivery was not contemplated by the parties.”<sup>203</sup> The judge also took note of the fact that the 15-day Brent contract enjoyed a high degree of standardisation of terms and that there existed investment or brokerage houses for Brent trading.<sup>204</sup> The judge further found that “[w]hile there is no contractual entitlement to satisfy Brent obligations by means other than delivery, the likelihood of avoiding delivery has enabled participants to develop what is essentially a ‘paper’ market for speculative or hedging purposes rather than one for physical transfer.”<sup>205</sup>

So the court did not find any difficulty in judging that, under the CEA, 15-day Brent contracts were “futures” contracts. As the judge stated, “[t]he volume of contracts traded and the high standardization of the contracts demonstrate the essential investment character of the 15-day Brent market. ‘With an eye toward [their] underlying purpose,’ the Court concludes that Transnor’s 15-day Brent transactions constitute futures contracts.”<sup>206</sup>

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<sup>200</sup> 738 F Supp 1472, at 1491-1492 (1990).

<sup>201</sup> 680 F 2d 573 (1982).

<sup>202</sup> *Id.*, at 1491.

<sup>203</sup> *Id.*, at 1492, quoting Securities and Investments Board, Consultative Document on the Future Regulation of the Oil Markets, at 2 (February 1988).

<sup>204</sup> *Id.*

<sup>205</sup> *Id.*

<sup>206</sup> *Id.*, at 1493.

Given the size and importance of the Brent crude oil market, the *Transnor* decision might worry many oil traders. Soon after the *Transnor* decision, to clarify the issue, the CFTC issued a statutory interpretation, which drew the conclusion that

“... a party to contracts of this type may individually negotiate cancellation agreements, commonly known as ‘book-outs,’ ‘close-outs’ or ‘by-passes,’ with other parties in a chain, circle or loop in a distribution chain and which may result in a cash payment-of-differences between the parties involved. It is noteworthy that while such agreements may extinguish a party’s delivery obligation, they are separate, individually negotiated, new agreements, there is no obligation or arrangement to enter into such agreements, they are not provided for by the terms of the contracts as initially entered into, and any party that is in a position in a distribution chain that provides for the opportunity to book-out with another party or parties in the chain is nevertheless entitled to require delivery of the commodity to be made through it, as required under the contracts.

Under these circumstances, the Commission is of the view that transactions of this type which are entered into between commercial participants in connection with their business, which create specific delivery obligations that impose substantial economic risks of a commercial nature to these participants, but which may involve, in certain circumstances, string or chain deliveries of the type described above, are within the scope of the ... exclusion from the Commission’s regulatory jurisdiction.”<sup>207</sup>

Two points in the CFTC’s conclusion may be noted. First, if the book-out is reached by an individually negotiated agreement rather than by a pre-determined method of settlement in an existing contract (as in *Voest Alpine*<sup>208</sup> discussed above), this is an indication that the relevant 15-day Brent trading contracts are for real commercial purposes rather than for speculation. Secondly, it seems that, if a 15-day Brent contract were made between commercial parties in connection with their business, this transaction would also fall beyond the jurisdiction of the CFTC.

There is no UK authority on the regulatory issue of the circle or book-out clause. Whether a contract is made for investment purposes or for commercial purposes depends on the interpretation of the RAO 2001 (see 3.1.2.1 above). Applying

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<sup>207</sup> CFTC Statutory Interpretation Concerning Forward Transactions, 55 Fed Reg 39188.

<sup>208</sup> [1987] 2 Lloyd’s Rep 547.

the analysis in *CR Sugar*<sup>209</sup>, it might be supposed that an English court would reach the same conclusion as that drawn by the CFTC, if the book-out is reached by individually negotiated terms<sup>210</sup> and parties actually produce or use Brent oil in their business.<sup>211</sup> In contrast, if the circle or book-out clauses are used as a means to conduct notional trading without any real intention to take or accept delivery of the underlying commodities, this might raise further regulatory concerns regarding notional trading. However, the intention of all relevant parties must be examined in order to reach a firm conclusion. It would increase the difficulty to argue that contracts with circle or book-out clauses should be regulated “futures” if one or more parties to a chain of sale intend the trade to result in a physical exchange of goods.

### 3.3.3 Contradictory Transactions Between Same Two Parties

Two contractual parties might insert a term in their contract(s) to initiate a book-out process to settle two or more transactions between them in cash. In this way, a customer might buy and sell commodities with the same seller without even possessing the commodities. The *Co Petro* case<sup>212</sup>, introduced in section 3.1.2.2 above, is a typical example. Two other American cases are worth mentioning.

In *MG Refining & Marketing, Inc v Knight Enterprises, Inc*,<sup>213</sup> the contract sold by MG Refining & Marketing (MG) to its customers (regarding gasoline or heating oil forward contracts) contained a “blow out” provision,

“which allowed the [c]ustomers to cash out their contracts and terminate any remaining delivery requirements in the event of a ‘price spike’ -- i.e. if the price of petroleum futures on the New York Mercantile Exchange (NYMEX) rose higher than a level stated in the contracts.”<sup>214</sup>

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<sup>209</sup> [2003] 1 Lloyd’s Rep 279.

<sup>210</sup> See RAO 2001, article 84(6).

<sup>211</sup> See RAO 2001, article 84(5).

<sup>212</sup> 680 F 2d 573 (1982).

<sup>213</sup> 25 F Supp 2d 175 (1998).

<sup>214</sup> *Id.*, at 177.

In this case, two types of contract were involved. One was called “ratables”.<sup>215</sup> The other was called “flexies” or “45-day”, under which the buyer (customer) nominates the lifting day 45 days in advance.<sup>216</sup> While many customers took delivery on ratables, no delivery was made under the 45-day contract, although delivery was required.<sup>217</sup>

The lawsuit arose in an unusual way. The CFTC had started to investigate MG’s 45-day contracts and decided that they were illegal and therefore void.<sup>218</sup> MG then duly notified its customers that the 45-day contract was illegal. However, a few months later, the oil prices in the NYMEX rose above the fixed price stipulated in the 45-day contracts and every customer “wrote in to MG and asked to exercise their contractual rights to cash out all of their flexies”.<sup>219</sup> When MG refused to cash out, customers sued MG for breach of contract, and MG counter-claimed that the 45-day contracts were illegal for violation of the CEA. Thus, the court was forced to decide whether the 45-day contracts were a cash forward or a regulated futures contract. While motions for summary judgment from both sides did not convince the judge, the court left this issue to trial because the purpose of the contract (speculative or for delivery) was not clear.<sup>220</sup>

In another case, *In re Bybee*<sup>221</sup>, Bybee conducted silver trading with A-Mark, partly on his own account and partly for his customers. Two forms of transactions took place between Bybee and A-Mark. The first was an immediate delivery sale; and the court found that, in 98% of cases, this type of transaction led to physical delivery. The second type, called “deferred delivery sale”, was more troublesome as Bybee and his customers did not have to take delivery on deferred delivery sales. Instead, they could make a down payment to A-Mark (with the balance secured by a lien on the undelivered metals) and

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<sup>215</sup> For a ratable contract, month deliveries were required on a ratable basis. The court did not give any more details as to how delivery was made on “ratable” basis. *Id.*, at 177.

<sup>216</sup> *Id.*, at 177-178. This distinction is similar to the Dated Brent and 15-day Brent. See also *Cary Oil Co, Inc v MG Refining & Marketing, Inc*, 230 F Supp 2d 439 (2002).

<sup>217</sup> 25 F Supp 2d 175, at 177 (1998).

<sup>218</sup> *Id.*, at 178.

<sup>219</sup> *Id.*

<sup>220</sup> *Id.*, at 183 *et seq.*

<sup>221</sup> 945 F 2d 309 (1991).

store the metal at A-Mark for up to two years. After a fall in silver prices, Bybee could not meet A-Mark's margin call and had to liquidate his trading with A-Mark at a loss. Failing to make up his shortfall via commodities trading, Bybee filed for bankruptcy protection. The trustee-in-bankruptcy then sought to rescind Bybee's transactions with A-Mark on the ground that they were off-exchange futures contracts and in violation of the CEA. The issue was whether their transactions fell within the cash forward exception.

Applying *Co Petro*<sup>222</sup> and the CFTC's interpretation,<sup>223</sup> the court first recognised that A-Mark represented that the metal contracts could be settled by offsetting contracts and held that the contracts in question were "futures" contracts.<sup>224</sup> Secondly, as to the cash forward, the court focused on the enforceability of the delivery obligation between Bybee and A-Mark and decided that "both A-Mark and Bybee had the legal obligation to make or take delivery upon demand of the other".<sup>225</sup> Thus, the contracts in question were held to fall within the cash forward exception.

These two cases represent a situation where a transaction between the same two parties might be settled with another contradictory transaction. If the same disputes were to face UK courts, UK judges might conduct a similar line of analysis by examining the parties' intention to make delivery.<sup>226</sup> In the *MG Refining* case, it is arguable that UK courts would also focus on the true nature of the trading scheme provided by MG. If the 45-day contract is used mainly for speculating rather than delivery of oil, it is quite likely that the 45-day contract would be held to be for investment rather than commercial purposes.

The two parties in *Bybee* did not really offset contradictory transactions and settle by cash (except when Bybee was unable to meet its margin call). Bybee or its clients might not hold the metals in person, but they might claim delivery of the metals if they so wanted. Thus, Bybee actually made profits from trading

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<sup>222</sup> 680 F 2d 573 (1992).

<sup>223</sup> See *supra* note 207.

<sup>224</sup> 945 F 2d 309 (1991), at 313.

<sup>225</sup> *Id.*, at 315.

<sup>226</sup> See RAO 2001, article 84(5)(b).

metals without putting metals into service or using them for consumption. This makes *Bybee* comparable to the *CR Sugar* case in England. In the end, it depends on whether the FSMA 2000 intends to regulate metal traders who have no interests in using metals into service or in manufacturing, but only in buying and selling metals for profits.

### **3.3.4 The Boundary of Futures Regulation: When Physical Sales Meet Notional Transactions**

#### **3.3.4.1 Objectives of Futures Regulation**

Having introduced hedge-to-arrive contracts (incorporating futures prices into a spot market trade and roll-over trades), circle or book-out clauses used to resolve a chain of sale (multi-party settlement of contracts), and book-outs between the same two parties (a bilateral trading scheme), what can we learn from the above discussion? On each occasion, the US court had to decide whether the contract in question was a regulated futures contract under the CEA and whether the contract was a cash forward contract for deferred delivery. UK courts and the FSA might face similar questions. In essence, this is about what kind of future delivery contracts should be regulated as “futures”. The policy concerns may vary country by country; thus, there is no need to assume that UK law should be interpreted in a way consistent with US law, or *vice versa*. However, could we develop a theory to rationalise futures regulation in the UK and the US? Such a theory would help to identify policy considerations and reduce legal uncertainties for commodity traders. To produce a theory like this, we must understand why we regulate off-exchange commodity forward contracts.

The regulatory objectives of the FSMA 2000 are to maintain confidence in the financial system, to raise public awareness of the financial system, to secure the appropriate degree of protection for consumers, and to reduce financial crimes.<sup>227</sup> The “financial system” includes financial markets and exchanges, regulated

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<sup>227</sup> FSMA 2000, sections 3–6.



activities, and other activities connected with financial markets and exchanges.<sup>228</sup> Thus, the FSMA 2000 has a strong interest in regulating the “financial market”, broadly speaking, which includes organised exchanges and the off-exchange market.

The regulatory objectives should be used as a guideline when interpreting related rules under the FSMA 2000. The distinction between commercial and investment purposes (see 3.1.2.1 above) also shows that the FSMA 2000 would govern future delivery contracts that are used as investments rather than for other commercial activities. However, the terms “investment” and “commercial” are both tricky words that are not mutually exclusive of each other. Since the indications given in the RAO 2001 are only guidelines rather than a checklist, having a proper understanding of what investment is might help us to interpret the FSMA 2000 and related rules in a correct way.

On the other hand, the implementation of the CEA in the US shows a strong desire to prevent market speculation. The promulgation of the CEA and its predecessors was a result of excessive speculation and price manipulation.<sup>229</sup> Thus, whether a contract may become a tool of speculation is an important criterion for US courts.<sup>230</sup>

Moreover, as was argued above, the structure of futures exchanges justifies the introduction of regulation owing to the price discovery function and the vulnerability of being open to abuse by speculators and market manipulators. However, this does not mean that off-exchange trading contracts have no implications for spot prices. There might be no centralised price bidding system, but the “invisible hand” still operates outside organised exchanges. It is not impossible to operate a market manipulation scheme in the spot commodity market. As a matter of law, the question is whether one should employ financial regulation to address the issue or rely on general competition law to deal with potentially abusive behaviour in the market.

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<sup>228</sup> FSMA 2000, section 3(2).

<sup>229</sup> *See CFTC v Co Petro Marketing Group*, 680 F 2d 573, at 577 (1982). *See also* Markham, *The History of Commodity Futures Trading and Its Regulation* (Praeger, 1987).

<sup>230</sup> *See Co Petro*, *id.*

Having observed various types of transactions, one could draw a continuum: at the one end are contracts of sale of goods whose delivery is made immediately; at the other end, futures exchanges provide facilities for multi-party trading and are now largely used for notional transactions. Between the two extremes, it is unavoidable that market participants have to buy or sell something that is delivered in the future. The temporal gap between the conclusion of the contract and delivery leaves some room for contractual parties to manoeuvre. Thus, parties might twist price terms (as in HTAs) or allow parties to roll delivery over to a later stage (e.g. rolling HTAs), to resolve a chain of sale (e.g. 15-day Brent contracts), or to settle multiple transactions between two or among several parties. On this basis, we will proceed to search for defining factors that distinguish regulated future delivery contracts from unregulated ones.

### **3.3.4.2 Delivery as the Defining Factor?**

From *CR Sugar* and US case laws introduced above, one may find that an obligation to make and accept delivery is an important factor when determining whether a contract is for commercial purposes or is a cash forward contract. Indeed, at the commercial end, the delivery of goods is the best illustration of a true “sale”.<sup>231</sup> Making and taking delivery is apparently evidence that a contract is for commercial purposes.<sup>232</sup> However, this thesis will argue that delivery should not be used as the only defining factor to distinguish unregulated commercial contracts from regulated futures contracts.

First, for a contract for future delivery, whether or not delivery is made is known only in hindsight. No problem arises if delivery has been made and accepted. However, in most cases, one may only examine the parties’ intention to see whether they really want the commodities to be delivered. But determining a party’s intention is not an easy task; for example, delivery might be rolled over several times (e.g. rolling HTAs; see 3.3.1 above), or a party might not even take physical control of the commodities, though he might demand to have physical

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<sup>231</sup> One American commentator seemed to emphasize that only a real sale could trigger the cash forward exception. *See* Norris, Davidson and May, “Hedge to Arrive Contracts and the Commodity Exchange Act: A Textual Alternative” (1999) 47 Drake L Rev 319.

<sup>232</sup> *See* Sale of Goods Act 1979, section 2(4). In the US, *see* UCC Article 2-106(1).

possession (e.g. *Bybee*<sup>233</sup>). Arguments resorting to parties' intentions would eventually have to depend on evidence, in the absence of a clear proof that neither party has any intention of making or taking delivery (e.g. in *CR Sugar*; see 3.1.1 above). Different judges might reach different conclusions. The Ninth Circuit Court was more generous in *Bybee*, but the District Court in New York was more stringent in *Transnor*. Relying on the intention to deliver is hardly satisfactory as there is no clear defining line and there might be legal uncertainties for commodity traders.

Secondly, another argument is that one may also make or take delivery through exchange trading, a primary target of futures regulation (see section 3.2.3.3 above). As Judge Easterbrook observed in *CFTC v Zelender*:

“[e]very commodity futures contract traded on the Chicago Board of Trade calls for delivery. Every trader has the right to hold the contract through expiration and to deliver or receive the cash commodity. Financial futures, by contrast, are cash settled and do not entail ‘delivery’ to any participant. Using ‘delivery’ to differentiate between forward and futures contracts yields indeterminacy, because it treats as the dividing line something the two forms of contract have in common for commodities and that both forms lack for financial futures.”<sup>234</sup>

Thus, it is not proper to rely on delivery or the intention to deliver as the sole standard for distinguishing unregulated commercial contracts from regulated futures, when a contract requires physical delivery.

Thirdly, as Judge Easterbrook also observed, there is a difference between financial assets (e.g. stock) and commodities (e.g. crude oil). In general, it may be assumed that one is making an investment when one buys a share in a company. It does not change the fact that a transaction is for investment purposes even if a stock is delivered. In contrast, a commodity transaction might be for commercial purposes (e.g. for further manufacture) or for investment purposes. For example, it is deemed a commercial activity if a person buys ten gold ingots and uses the gold to produce golden rings for further

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<sup>233</sup> 945 F 2d 309 (1991).

<sup>234</sup> 373 F 3d 861, at 865 (2004).

sale in the market. In contrast, a person buys ten gold ingots, stores them in his house, and expects to sell them if the gold price moves to a good position. Literally, this is still an investment, but whether this kind of activity requires regulation is a question that regulators should consider. Delivery might be one important criterion, but it does not really provide a clear line between commerce and investment.

Fourthly, it is inappropriate to assume that non-delivery (or the lack of intention to make delivery) makes a transaction regulated “futures”. If one accepts that delivery (or the intention to make delivery) of an off-exchange commodity contract makes a transaction commercial, it immediately follows that non-commercial transactions (i.e. for investment purpose under UK law) do not require delivery. It would be a logical error to assume that non-delivery (or the lack of intention to make delivery) makes a transaction non-commercial, as a seller might not make delivery for several reasons: he might simply want to breach the contract, or he might be excused for non-delivery for other legal reasons (e.g. frustration). Nevertheless, these situations are not seen as signs that such a contract would be a regulated “futures” contract. Thus, the defining line must derive from other factors.

Lastly, we are currently focusing on individual contracts to determine whether parties have made delivery or have the intention to do so. However, we usually take into account several transactions between (or among) parties before determining whether relevant contracts for delivery are legally “futures”. In short, contracts between parties become “futures” through consideration of the whole trading scheme rather than individual contracts. In *CR Sugar, Co Petro, MG Refining*, and *Bybee*, multiple transactions took place between the same two parties. In *Transnor*, the US court analysed the general usage of 15-day Brent contracts in the spot oil market.<sup>235</sup> Focusing on how contracts of the same type are performed enables judges to observe how transactions are conducted overall (including delivery and non-delivery) before making a decision.

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<sup>235</sup> However, in *Transnor*, only one transaction took place between the two parties. It is apparently more difficult to judge the nature of a whole trading scheme if there is only one transaction between parties.

In short, delivery or the intention to make or take delivery is a sign that a transaction is for commercial purposes. However, delivery and the intention to make delivery should not be the defining factors for distinguishing regulated “futures” contracts and unregulated commercial contracts.

### **3.3.4.3 Reference from Exchange Trading**

The focus will now be on exchange trading. We may recall some key characteristics of the exchange market discussed above (section 3.2.4): 1) the standardisation of contractual terms; 2) public bidding to set prices; 3) multi-party trading structure and intervention by clearing houses; 4) margin and mark-to-market approaches; and 5) off-setting transactions. Each characteristic will be examined in turn.

First, it might be supposed that a commodity exchange must have standardised contracts. However, this only leads to the conclusion that a lack of standardised contracts bars a trading scheme from also being an exchange. In addition, it is odd to argue that standardisation of contract alone is the basis of futures regulation. Otherwise every transaction with standard documentation provided by trade associations might become futures contracts. In other words, the presence of standardised terms might be an indication that a trading scheme is a futures exchange, but it does not help to decide whether an off-exchange contract should be a regulated “futures” contract as a matter of law.

Secondly, public bidding of prices is a trademark of the exchange market. However, it may also be argued that public bidding of prices is an indication that a trading scheme is like a futures exchange. Again, we might ask a question: whether public bidding of prices is the major factor that leads to exchange regulation? There are plenty of public bidding or auction systems in the world to allow buyers and sellers to make transactions; however, not all of them are regulated as exchanges. (EBay, the most well-known online auction platform, is probably the best example.) This does not mean that public bidding of prices might not attract regulation, as maintaining the integrity of market prices is apparently an important job for every government. The argument is simply

that a trading scheme might not be an exchange without a public bidding of prices. But this does not answer the question whether off-exchange trading contracts should be regulated.

Thirdly, the intervention of a clearing house is one important characteristic of exchange trading. Under UK law, it is also an indication that a contract is for investment purposes if “performance of the contract is ensured by an investment exchange or a clearing house”.<sup>236</sup> Two arguments may be taken against using the clearing house as a defining factor for regulated future delivery contracts. On the one hand, it is not impossible that delivery is intended to take place via a clearing house; thus, one might reach one’s commercial goals (e.g. acquiring metals) via a clearing house.<sup>237</sup> On the other hand, if we accept that exchange trading must have an accompanying clearing house, it follows that a trading scheme cannot be an exchange without a clearing house. A transaction might easily be deemed as a regulated futures contract if it is cleared through a clearing house, despite the fact that the transaction is conducted off an organised exchange.<sup>238</sup> Nevertheless, when an off-exchange transaction does not pass through a clearing house, the argument emphasizing the intervention of a clearing house loses its force. In short, the existence of a clearing house might be a contributing factor, but it does not directly provide an answer to whether an off-exchange contract should be regulated.

Fourthly, the margin and mark-to-market strategy is not exclusive to exchange trading, as the same approach might be used for off-exchange commodity trading contracts<sup>239</sup> and even spread betting contracts.<sup>240</sup> After all, margin is collateral, and parties are free to make collateral agreements to meet specific needs.

This leaves one crucial characteristic of future exchanges: the possibility to offset contrary trades. Offsetting contrary transactions makes the whole trading

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<sup>236</sup> RAO 2001, article 84(7)(b).

<sup>237</sup> For example, through the Sword system developed by the LCH and the LME, a metal trader might have good access to storage of metals around the world if OTC clearing for metal contracts is allowed. *See supra* 3.2.3.3.1.

<sup>238</sup> *See* RAO 2001, article 84(7)(b).

<sup>239</sup> For example, *see In re Bybee*, 945 F 2d 309, at 313 (1991).

<sup>240</sup> *See Spreadex Ltd v Battu* [2005] EWCA Civ 855.

scheme notional, and notional transactions facilitate speculation. By cancelling out trading contracts, the contract itself becomes a unit of trade and might then be turned into a means to conduct risk trading. In essence, notional transactions trade “in the contract” while physical transactions trade “in the commodity”.<sup>241</sup> It is in cases of the former type that financial regulators have an interest to intervene.

Thus, this thesis argues that the boundary of commodity futures regulation lies at the turning point between notional sales and physical sales. The key factor is whether a trading scheme provides the possibility to offset contrary trades. The contractual parties’ lack of intention to make delivery is an indication that relevant transactions are conducted on a notional basis. The standardisation of contracts, public bidding of prices, the intervention of clearing houses and the use of margin and/or mark-to-market strategy are all contributing factors to help to identify whether a trading scheme is notional.

*Co Petro*<sup>242</sup> provides a typical example because the trading scheme is largely notional (see 3.1.2.2 above). In contrast, we believe that the HTAs, though using complicated price terms, were still largely used by farmers and grain merchants to trade grain; thus, the US courts were right to leave the HTAs outside the reach of the CFTC.

The *Transnor*<sup>243</sup> judgment might require further thought (see 3.3.2 above). It cannot be denied that some people might use the same 15-day Brent contract to earn oil price differences. However, book-outs under 15-day Brent contracts normally require two or more parties (such as in *Voest Alpine*<sup>244</sup>; see 3.3.3 above). It may be argued that whether a 15-day Brent contract is notional or physical should be determined on a factual basis, rather than on how most market participants use the contract. If all relevant parties in a circle intend to abuse the circle or book-out clause as a means to conduct off-exchange trading, this opens the door for the contracts to be regulated as “futures”. In contrast, if the circle or

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<sup>241</sup> These are terms used by Judge Easterbrook in *CFTC v Zelender*, 373 F 3d 861, at 867 (2004).

<sup>242</sup> 680 F 2d 573 (1982).

<sup>243</sup> 738 F Supp 1472 (1990).

<sup>244</sup> [1987] 2 Lloyd's Rep 547.

book-out clause is used only for the purpose of shortening a circle, there seems to be no reason to regulate such commercial activities through financial regulation.

The *Bybee* case provides another challenge (see 3.3.3 above). The “deferred delivery sale” allowed Bybee to take advantage of future price movement of precious metals with a down payment (thus resembling leverage). Bybee did not really take possession of the metals, and the court even found that A-Mark implicitly represented that it would provide for offsetting contracts.<sup>245</sup> Nevertheless, the Ninth Circuit Court emphasized the delivery obligation laid down in their contracts. It may be argued that the US court was rather too lenient towards Bybee. According to the notional transactions theory proposed above, the Bybee/A-Mark transactions look more notional than physical. However, this is not all bad news for commodity traders. Compared with *CR Sugar*, the Ninth Circuit Court was generous towards them.

#### **3.3.4.4 Investment and Commodity Traders: A Review of *CR Sugar***

Finally, this discussion returns to the *CR Sugar* case,<sup>246</sup> which raised the essential question of how far the FSMA 2000 wants to regulate commodity traders who buy and sell commodities as principals without actually putting the commodities into manufacturing or other services. Should transactions made by these traders be seen as investments or as commercial activities? These questions are not fully answered by the *CR Sugar* judgment. Three points deserve attention.

First, we may consider the meaning of “investment” in this context. Common sense suggests that one may make an investment simply by buying and holding a commodity (e.g. gold) or a property (e.g. real estate). However, for the most part, investment consists in an investor placing some money as a stake in exchange for future monetary return. Thus, the physical/notional theory may also help clarify the distinction between futures for commercial purposes and for

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<sup>245</sup> 945 F 2d 309, at 313 (1991).

<sup>246</sup> [2003] 1 Lloyd's Rep 279.



investment purposes under FSMA 2000. (Perhaps one day the FSA will be interested in regulating real estate agents or those who buy and resell commodities as their main business, though so far we have seen no such move to expand the FSA's jurisdiction to transactions that are traditionally seen as being more commercial than financial.) From this perspective, CR Sugar should be immune from the FSMA 2000.

Juxtaposing the European perspective for comparison shows that the Directive on Markets in Financial Instruments (MiFID) actually exempts from regulation "persons whose main business consists of dealing on [their] own account in commodities and/or commodity derivatives".<sup>247</sup> Assuming that CR's main business is dealing in sugar on its own account, the put options with CSW might be enforced under the MiFID.

Secondly, CR's trading of sugar options might not be a regulated activity, provided that the options were used for risk management purposes and that CR's main business consisted mainly of activities other than regulated activities.<sup>248</sup> It is not quite clear whether CR purchased the options to hedge its other business or, as Steel J implied, simply to create trading positions to support CR's futures trading in New York. However, it is impossible to say whether Steel J would have exempted CR from the application of the Financial Services Act 1986<sup>249</sup> as CR did not make arguments from this perspective.

Thirdly, the *CR Sugar* case was more challenging than other US cases because it involved put options rather than a straightforward future delivery contract. This raises the question whether we should examine the purpose of the "options" or the purposes of the underlying forward transaction. Steel J seemed to adopt the former approach. However, a literal reading of the RAO 2001 might suggest that an option is a regulated investment if it is an option to acquire another investment.<sup>250</sup> Thus, only options to acquire futures contracts for investment purposes should be regulated investments. If this construction is correct, the

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<sup>247</sup> Directive 2004/39/EC, article 2.1(k).

<sup>248</sup> RAO 2001, article 19.

<sup>249</sup> See *supra* note 10 for the explanation of the applicable law in the *CR Sugar* case.

<sup>250</sup> See RAO 2001, article 83.

focus should be on the purpose of an option's underlying future delivery contract rather than the option itself.

Overall, this thesis supports Steel J's holding that the time to determine the intention and purpose of an option is the time when both parties enter into the transaction rather than when the option is exercised, as this could make the application of law less uncertain. But a subtler issue is to ascertain the essential characteristic of a commodity option. The main difficulty in identifying the real intention behind commodity options comes from the fact that there is always a chance that an option will not be exercised (otherwise there would be no point in buying an option rather than entering into a straight future delivery contract). Thus, there is always a certain degree of speculation in any option trading. However, there is no doubt that an option might also be used for commercial (rather than investment) purposes.

On the other hand, an option is subject to be exercised one day; otherwise there would be no point in CR continuing to pay premiums for these options. Steel J found out that CR and CSW had no intention to deliver, and the main purpose of these options was to allow them to make a profit.<sup>251</sup> However, how exactly the parties made a profit from the options was not fully explained. Another critical fact is that the put options were deeply out of money when they were written,<sup>252</sup> and thus it seems that the parties did not really expect the exercise of the options in the first place. This fact strengthens an argument that the main purpose of these put options was to create fictitious trading positions to allow CR to conduct futures trading in New York. Therefore, the whole trading scheme between CR and CSW looks more like sham transactions. This provides a further angle to examine the put options in the *CR Sugar* case: should the options in question be regulated because they were investments or should they be regulated because they were merely sham transactions? In the latter case, it is arguable whether the FSA has an interest in regulating them in the UK.

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<sup>251</sup> [2003] 1 Lloyd's Rep 279, at 281.

<sup>252</sup> *Id.*, at 180.

In sum, *CR Sugar* is a difficult case, but this does not mean that the *CR Sugar* judgment is wrong. *CR Sugar* sits on the boundary between physical trading and notional trading. The options were not clearly notional as they were not settled by cash and there were no contradictory trades. In contrast, they were not clearly physical as no intention to deliver was found, and the only request for delivery was rejected by CSW. In the end, this may come down to the FSA clarifying the scope of regulated commodity options and whether commodity traders come within its jurisdiction, especially after the implementation of the MiFID from 1 November 2007.<sup>253</sup>

### 3.4 Conclusion: the Future Ahead

In this chapter, we have illustrated how hedging contracts are developed in commodities sales through standardised trading. By the clearing house stepping into every transaction (helped by numerous novations or substitutions), along with the margin requirement (and the mark-to-market approach), credit risk is greatly reduced and traders have more flexibility to acquire new contracts or to sell existing contract positions. Thus, exchanges have effectively been transformed from physical trading markets into notional markets, where the “contract” is the unit of trade instead of the underlying commodities. In short, exchange trading has moved from real sales to a battleground for “differences”.

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<sup>253</sup> The MiFID considers options, futures, swaps, forwards and any other derivative contracts relating to commodities as financial instruments if they are not for commercial purposes. See Directive 2004/39/EC, Annex 1, section C(7). The Commission Regulation (EC) 1287/2006 (MiFID Regulation) further provides certain characteristics to determine whether an instrument is an “other derivative instrument” under section C(7) of Annex 1 of the MiFID and to decide whether a commodity contract is for commercial purposes. The statutory language is rather complex and all details would not be repeated here. To summarise, a commodity transaction is deemed not for commercial purpose if it is subject to rules of an exchange (or is expressly stated to be equivalent to a contract traded on an exchange), is cleared by a clearing house, or is standardised so that the price, the lot, the delivery date and other terms are determined principally by reference to regularly published prices, standard lots, or standard delivery dates. See MiFID Regulation, article 38.

If we apply MiFID and MiFID Regulation to the *CR Sugar* case, we may find that the put options in question are most likely not a spot contract; however, they are also not clearly considered “not for commercial purpose” if we apply article 38 of MiFID regulation. It may still be an open question whether the put options in *CR Sugar* should be considered as for commercial purposes (because they do not fall within the criteria listed in article 38(1)) or may still be considered not for commercial purpose (if article 38(1) does not represent a complete list of characteristics).

Nevertheless, financial regulations also use the term “futures” to cover exchange-traded commodity contracts and some off-exchange commodity transactions. To make current UK and US law more rational, it is proposed that the boundary of futures regulation be taken to lie on the point of transition from physical sales to notional sales. Under the FSMA 2000, physical sales are carried out for commercial purposes whereas notional sales are carried out for investment. Although there is no easy way to clarify the grey area where trading contracts might incorporate certain derivative techniques (e.g. prices referring to futures prices, roll-over terms, and book-out clauses), keeping in mind the distinction between notional and physical transactions might help in drawing more consistent conclusions on a variety of commodity transactions.

Lastly, the discussion in this chapter might be relevant in other new markets. For example, the trading of bandwidth, property, and in particular carbon emissions might follow the route of agricultural or energy products. At one point, carbon emissions trading might enter a stage where market participants buy or sell emissions quotas notionally to hedge or to speculate. The discussion presented in this thesis might one day be applied to tackle new problems that develop from the new markets.

## Chapter 4 Notional Transactions, Speculation and Gambling

In this chapter, we will focus on whether cash-settled derivative instruments (“notional transactions”) are any different from gambling. The term “gambling” (or betting, wagering, etc.) can be used in different ways. On the one hand, it may narrowly mean a specific transactional structure (such as bookmaking, pool betting, lottery, etc.) that we will call a “traditional gambling instrument” in this chapter. On the other hand, it can broadly refer to transactions intended to make a windfall from the occurrence, non-occurrence or the outcome of a future event.

The term “gambling” easily attracts criticism and controversy. However, as we will explain below, one significant difficulty of tackling issues relating to gambling is to define the term “gambling” (or other associated terms such as wagering or betting). This often results in a chicken-egg problem: we would like to argue that an instrument is, or is not, a kind of gambling, but at the same time we cannot define what gambling is or is not.

In this chapter, we will attempt to explore not only whether derivative instruments are gambling under English law but also examine the underlying rationale behind modern gambling laws to see why gambling is treated differently and how market speculation could be controlled. We will argue that notional transactions, if used for speculative purposes, are not much different from gambling in nature, or to use a more civil law term, whether or not notional derivative instruments are aleatory contracts. Then, the question is whether we should treat these instruments like traditional gambling instruments. We will examine certain legal and academic arguments developed under English law and American law. In the end, we will attempt to establish a platform that may host

different policy considerations on the matter of gambling and notional transactions in different countries. For simplicity, this chapter will focus on OTC derivative instruments rather than exchange-traded and hybrid products.<sup>1</sup>

## 4.1 Introduction

The question as to whether risk trading instruments constitute gambling may have significant legal implications. First, gambling frequently invites negative legal consequences. As will be explained below, a gambling contract may be unenforceable and a punter might even be penalised for gambling (see section 4.2 below). Secondly, market speculation can sometimes trigger financial regulations,<sup>2</sup> if we accept that speculation is not greatly different from gambling (see section 4.4.1 below). In law, the best way to approach the issue is on the basis of judicial judgments. Thus, in the following sections, we will first examine the *Morgan Grenfell* case in the UK. Then we will comment on the judgment and elaborate on the need to for further arguments.

### 4.1.1 The *Morgan Grenfell* case

The UK court provides us with the most modern judgment on the matter of gambling and notional transactions. In *Morgan Grenfell & Co Ltd v Welwyn Hatfield District Council*,<sup>3</sup> the defendant (Islington council) raised the question as to whether an interest rate swap was unenforceable as a type of wagering or gaming contract.

The case involved back-to-back interest rate swaps (see section 2.2.2.3 below). The first swap was between Morgan Grenfell (MG) and the Welwyn council, as the fixed rate payer and floating rate payer, respectively. The terms the second swap were almost identical, except that Welwyn council was the fixed rate payer and Islington council was the floating rate payer. In the aftermath of the local authorities cases (see section 2.3.1 above), Welwyn council sued Islington

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<sup>1</sup> See *supra* 2.2.2.1 for the distinction between exchange-traded, OTC and hybrid instruments.

<sup>2</sup> For example, one of the principal objectives of the US Commodity Exchange Act is to prevent excessive market speculation and manipulation. See *supra* 3.3.4.1.

<sup>3</sup> [1995] 1 All ER 1.

council to recover the money it had paid on the ground of restitution. The Islington council counter-claimed that the interest rate swap was unenforceable as a wagering or gaming contract. Another issue was, if the interest rate swap between Welwyn council and Islington council was wagering, whether or not section 18 of the Gaming Act 1845 was excluded by section 63 of the Financial Services Act 1986.<sup>4</sup>

It is necessary to have some understanding of the law in effect at that time. Before the Gambling Act 2005, section 18 of the Gaming Act 1845 provided that “[a]ll contracts or agreements, by way of gaming or wagering, [were] null and void”.<sup>5</sup> The purpose of this section was to prevent the winner (of a bet) from suing the loser for the prize, so as to frustrate gaming.<sup>6</sup>

The matter then centred on the meaning of “by way of gaming or wagering”. The classic definition of “gaming or wagering” was given by Hawkins J in *Carlill v Carbolic Smoke Ball*:

“a wagering contract is one by which two persons, professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, dependent upon the determination of that event, one shall win from the other, and that other shall pay or hand over to him, a sum of money or other stake; neither of the contracting parties having any other interest in that contract than the sum or stake he will so win or lose, there being no other real consideration for the making of such contract by either of the parties. It is essential to a wagering contract that each party may under it either win or lose, whether he will win or lose being dependent on the issue of the event, and, therefore, remaining uncertain until that issue is

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<sup>4</sup> Before the Gambling Act 2005, section 412 of the Financial Services and Markets Act 2000 (FSMA 2000) also excluded the application of section 18 of the Gaming Act 1845. However, section 334 of the Gambling Act 2005 has repealed section 18 of the Gaming Act 1845 and the relevant part in section 412 of the FSMA 2000.

<sup>5</sup> A similar statute can be traced back to as early as 1710. Section 1 of the Gaming Act 1710 rendered void a security given for money, etc, won by gaming or betting or for repayment of money lent for gaming. Section 334 of the Gambling Act 2005 repealed both section 18 of the 1845 Act and section 1 of the 1710 Act.

<sup>6</sup> In Hawkins J’s words, the purpose of section 18 “was not to render illegal wagers which up to that time had been lawful, but simply to make the law no longer available for their enforcement, leaving the parties to pay them or not as their sense of honour might dictate”. *Read v Anderson* (1882) 10 QBD 100, at 104. See also Mier, *Regulating Commercial Gambling: Past, Present, and Future*, at 237–238 (OUP, 2004).

known. If either of the parties may win but cannot lose, or may lose but cannot win, it is not a wagering contract.”<sup>7</sup>

For a contract to be a wager, one party must be the winner and the other the loser.<sup>8</sup> The basic test for determining whether a contract constitutes gaming or wagering was to look at the intentions of the relevant parties. The court would look into the substance of a transaction rather than “the mere words in which it is expressed”.<sup>9</sup> Both parties must have intended the transaction to be gaming or wagering.<sup>10</sup> In Lord Hanworth’s words, “[i]t may be more accurate to say that if there is no other purpose in the contract than that of gaming or wagering, it is void—the interest of the parties [is] evidence of the purpose for which it is entered into”.<sup>11</sup>

On this basis, Hobhouse J analysed the contracts in *Morgan Grenfell*. First, Hobhouse J opined that interest rate swap contracts were contracts “which may or may not be wagering contracts”, in contrast to certain contracts that were “by their very character gaming or wagering contracts, such as a bet upon what horse [would] win a particular race”.<sup>12</sup> Hobhouse J then recognised that

“[interest rate swaps] have at least potentially, a speculative character deriving from the fact that the obligations of the floating rate payer are to be ascertained by reference to a fluctuating market rate that may be higher or lower than the fixed rate at any given time. Such a contract is capable of being entered into by two parties with the purpose of wagering upon future interest rates.”<sup>13</sup>

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<sup>7</sup> [1892] 2 QB 484, at 490–491. This definition is not completely correct in certain aspects. For example, people could wager not only on future uncertainties but also on past events. See James, *Law of Derivatives*, at 23 (LLP, 1999).

<sup>8</sup> *Tote Investors Ltd v Smoker* [1968] 1 QB 509, at 516 (*per* Lord Denning).

<sup>9</sup> *Earl of Ellesmere v Wallace* [1929] 2 Ch 1, at 25; *Morgan Grenfell & Co Ltd v Welwyn Hatfield District Council* [1995] 1 All ER 1, at 7.

<sup>10</sup> See *Carlill v Carbolic Smoke Ball Co* [1892] 2 QB 484; *Thacker v Hardy* (1878) 4 QBD 685; *Universal Stock Exchange, Ltd v Strachan* [1896] AC 166; *City Index Ltd v Leslie* [1992] QB 98; *Morgan Grenfell & Co Ltd v Welwyn Hatfield District Council* [1995] 1 All ER 1. For New York and Illinois law, see also *People v Posner*, 7 NE 2d 93 (1937); *Salzman v Boeing*, 35 NE 2d 536 (1941).

<sup>11</sup> *Earl of Ellesmere v Wallace* [1929] 2 Ch 1, at 25 (*per* Lord Hanworth).

<sup>12</sup> [1995] 1 All ER 1, at 7

<sup>13</sup> *Id.*, at 7–8.



On the other hand, Hobhouse J also recognised that interest rate swaps might also be used as a commercial tool.<sup>14</sup> He held that

“[i]n the context of interest rate swap contracts entered into by parties or institutions involved in the capital market and the making or receiving of loans, the normal inference [would] be that the contracts are not gaming or wagering but [were] commercial or financial transactions to which the law [would], in the absence of some other consideration, give full recognition and effect.”<sup>15</sup>

Then, Hobhouse J proceeded to examine the interests and objectives of both councils. As to Islington, the judge held that the council had not entered into the transaction for the purpose of wagering. It was found that

“the purpose, and the effect, was to incur a revenue liability spread over a period of ten years in exchange for an advance payment to be made at the time of entering into the contract which could be treated by Islington as a revenue receipt. ... It was not the purpose or motive of Islington to speculate or to seek profits by speculating. Any such profit or loss would be coincidental to the main purpose ... This speculative element was involved in the transaction solely because of the contractual mechanism which Islington were using to obtain, in their revenue account, loans from the later years to the first year.”<sup>16</sup>

In contrast, Welwyn was central to the structure of the back-to-back swaps. In effect, Welwyn’s obligation in this transactional structure was limited, and it could earn an “assured element of profit” by interposing itself between Islington and MG.<sup>17</sup> Thus, Hobhouse J found that Welwyn did not enter into any speculation in this transaction. To quote the judge’s words,

“Welwyn wholly insulated itself from any speculative risk. Whatever the movement in interest rates, their element of profit would remain the same and they would not be exposed to any loss. The insolvency risk was commercially negligible and Welwyn did not expect or foresee any legal risk. The purpose and interest of Welwyn was to realise a non-speculative

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<sup>14</sup> *Id.*, at 8–9, quoting *Hazell v Hammersmith and Fulham London Borough Council* [1992] 2 AC 1, at 23–24 (*per* Lord Templeman).

<sup>15</sup> *Id.*, at 10.

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

<sup>17</sup> *Id.*, at 11. In fact, the Welwyn received an outright profit of £210,000 at the commencement of the swaps. *Id.*, at 4.

profit and was in no way directed to or concerned with gaming or wagering.”<sup>18</sup>

Therefore, “[i]n the present case the relevant transactions are *prima facie* of a commercial and financial character. The purpose and interest of Welwyn in entering into those transactions confirms that they were not wagering transactions”.<sup>19</sup> In sum, both Islington and Welwyn entered into the interest rate swap transactions with commercial purposes, and thus the transaction was not considered to be a wager.

Hobhouse J argued that even if the interest rate swaps had been wagers, the transactions would have fallen within the ambit of the Financial Services Act 1986.<sup>20</sup> Islington also argued that the swap was not entered into “by way of business”. Hobhouse J took a broad view of the term “business”, which “clearly should not be given a technical construction but rather one which conforms to what in ordinary parlance would be described as a business transaction, as opposed to something personal or casual.”<sup>21</sup> Thus, Islington’s swap agreements were held to be within the ambit of business activities.

#### 4.1.2 Comments on *Morgan Grenfell*

The *Morgan Grenfell* case seems to provide a practical resolution of the danger that a derivative instrument might be characterised as a gaming or wagering contract under English law. Hobhouse J’s conclusion is largely justified; however, a few points about this judgment may merit further consideration.

First, the starting point of Hobhouse J’s judgment is the assumption that some contracts are intrinsically gaming or wagering (e.g. bookmaking), while some contracts are not necessarily so (thus requiring an examination of the intentions of the parties). However, the judgment does not make it clear as to what are the contracts that are “by character” gaming or wagering.

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<sup>18</sup> *Id.*, at 11.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*, at 11-13.

<sup>21</sup> *Id.*, at 13.

If we broaden our research, we may find that gaming or wagering is just one type of a broadly defined category of “gambling”. In fact, Hobhouse J also uses terms such as “betting” and “bookmaking” in the *Morgan Grenfell* judgment. Indeed, certain instruments are commonly seen as “gambling”: bookmaking, pool betting, and lotteries are the best examples (see section 4.2.1 below). However, it is less clear for some instruments (e.g. spread betting; see section 4.2.1 below). As Lord Wilberforce observed,

“[i]t is impossible to frame accurate definitions which can cover every such variety; attempts to do so may indeed be counter-productive, since each added precision merely provides an incentive to devise a variant which eludes it. So the legislation contains a number of expressions which are not, or not precisely, defined: bet, wager, lottery, gaming, are examples of this.”<sup>22</sup>

Hobhouse J’s observation that certain instruments are by character gaming or wagering, though highly plausible, fails to leave clear guidelines on what is a wagering (or broadly speaking, gambling) contract. As James comments, Hobhouse J does not “offer any real guidance as to what the features of a contract are that make it a wagering transaction.”<sup>23</sup>

Secondly, in *Morgan Grenfell*, Hobhouse J held that the relevant transactions were “*prima facie*” of a commercial and financial character.<sup>24</sup> This assumption could be traced to the basis of modern contract law. Under the principle of freedom of contract, two parties should have the liberty to make their own contract unless it is contrary to public policy or statute. This analytical structure should also be applicable to risk trading. Instead of jumping directly to gambling laws, the starting point should be to assume that a transaction is, in principle, legal and enforceable.

In contrast, English law seems to start by defining what is not wagering rather than by confining the application of gambling laws to those cases defined as wagering. This relates to the previous point that wagering is hard to define.

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<sup>22</sup> *Seay v Eastwood* [1976] 3 All ER 153, at 155.

<sup>23</sup> James, *The Law of Derivatives*, at 26 (LLP, 1999).

<sup>24</sup> [1995] 1 All ER 1, at 9 & 11.

English law minimises the drawback of this approach by holding that a party does not enter into a transaction by way of wagering if he has any other purpose than pure speculation.<sup>25</sup> However, this approach cannot deal with the basic question: what is wagering (or gambling or speculation) and what are the basic concerns that underlie the law dealing with wagering (or gambling or speculation)?

Thirdly, the *Morgan Grenfell* case dealt with a situation where a contract might become unenforceable if it was characterised as wagering. Two points may be developed from this. On the one hand, the UK law has changed since the *Morgan Grenfell* judgment. Under the Gambling Act 2005, social and non-commercial gambling is now legalised and section 18 of the Gaming Act 1845 has been abolished.<sup>26</sup> The term “wagering” is no longer in use. The regulatory scheme is no longer that of 1995. Rather than centring on whether the instrument is enforceable, the issue we now face is whether a firm selling derivative instruments should be considered a gambling business (see section 4.2.2.1).

On the other hand, bookmakers were already regulated by the Betting, Gaming and Lotteries Act 1963 before the Gambling Act 2005 came into force. Thus, using bookmaking as a direct comparison with unenforceable wagering may not be appropriate because there are different concerns behind the unenforceability rule and the licensing scheme for bookmaking. A better overview of financial and gambling regulation as a whole is necessary if we are to understand the rationale behind gambling and speculation.

Fourthly, we noted that Hobhouse J seemed not to distinguish “speculation” from “wagering”. However, since market speculation might serve an important market function, one might argue that market speculation is different from wagering. Even if a notional transaction is purely for speculation, should it be regulated as gambling or as a financial instrument? This aspect of notional

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<sup>25</sup> James comments that “[t]he only answer at the moment is that the judiciary have been unable define what it is that makes a transaction wagering, but presumably feel that they can recognise a wagering contract when they see one. It might come down to the ability to identify a purpose in entering into, or a benefit from, the transaction beyond purely the profit that the transaction might bring.” James, *supra* note 23, at 25.

<sup>26</sup> Gambling Act 2005, section 334.

transactions was not fully considered in the *Morgan Grenfell* judgment. We will examine this point later (see section 4.4.1 below).

Fifthly, the statutory exemption of gambling laws is not unique to the UK.<sup>27</sup> In the US, both the Commodities Exchange Act and securities regulations exempt regulated contracts from state bucket shop or gambling laws.<sup>28</sup> The main purpose of this exemption was to remove legal uncertainties.<sup>29</sup> Two legal implications could arise from this. On the one hand, for derivative instruments in the UK and the US, the focus could shift to whether or not a contract is a regulated transaction, which might imply there is no need to use gambling laws to control speculation as long as a contract is within the reach of financial regulator.<sup>30</sup> On the other hand, it might mean that a derivative transaction, if outside the reach of financial regulation (e.g. not by way of business), is no different from gambling and thus might be regulated as a gambling contract. We will develop these two lines of analysis later (see section 4.4.3 below). A contrasting approach would be to inquire whether gambling contracts might simply be regulated as contracts for differences (assuming that gambling contracts are settled in cash).<sup>31</sup>

In essence, *Hobhouse J* seemed to assume that certain instruments were by all means wagering. However, as we will argue below, traditional gambling instruments might also be used to hedge risks, or for other business purposes. Perhaps it is better to assume that the sole intention of placing a bet on a horse is

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<sup>27</sup> See Financial Services and Markets Act 2000 (FSMA 2000), section 412 (repealed by Gambling Act 2005, section 334).

<sup>28</sup> 7 USCA 16(e)(2); see also 15 USCA 78bb(a) (the Securities Exchange Act of 1934).

<sup>29</sup> [1995] 1 All ER 1, at 13.

<sup>30</sup> See for example, *City Index Ltd v Leslie* [1992] QB 98 (spread betting and contract for differences).

<sup>31</sup> Cf. *City Index Ltd v Leslie* [1992] QB 98. In this case, Mr. Leslie conducted spread betting with City Index (which was both licensed as a bookmaker and an authorised person to conduct investment business) and suffered some losses. While City Index sued Leslie for the money owed, Leslie counterclaimed that the transactions between parties were void under the then section 18 of Gaming Act 1845. The issue then was whether the transactions were contract for differences under the Financial Services Act 1986 so that the application of the Gaming Act 1845 would be exempted. In the end, the court took a literal reading of relevant statutory texts that the term “secure a profit” simply meant obtaining (rather than protecting) a profit, and held that the spread betting contracts between parties fell within the category of “contract for differences”.

to wager, rather than to assume that a bet on a horse is by character wagering (see 4.4.1 below).

Although, in the wake of the *Morgan Grenfell* case and the introduction of the Gambling Act 2005, the following discussion may seem more academic than of any practical value, there are several reasons why it will be beneficial to have a more thorough examination of gambling and notional transactions. First, gambling is still prohibited in many countries. A transaction might be lawful and enforceable in the UK, but legal uncertainties remain in other jurisdictions. An underlying rationale for identifying different policy concerns and academic arguments is still useful.

Secondly, in the future more and more derivative instruments will be developed to enable market participants to speculate on the market. In a way, gambling and notional speculative derivative instruments are all contracts to trade risks. After all, both traditional gambling instruments and notional derivative instruments hinge upon the outcome of a future uncertainty. It is necessary to have an overview of the whole financial and gambling regulation to devise a best regulatory solution.

In the following sections, we will start by looking at traditional gambling instruments to see the types and legal consequences of what is generally seen as gambling. Then we will explain why gambling receives negative legal treatment, and argue that market speculation actually shares many of gambling's evils. We will further examine certain conceptual arguments that distinguish gambling and derivatives/hedging/speculation. We will also consider whether it is feasible to borrow the insurable interest test from insurance law and apply it to notional derivative transactions. Finally, we will attempt to establish an analytical structure for the use of notional transactions in different contexts to resolve the application of gambling laws to risk trading contracts.

## 4.2 Types of Gambling and their Legal Consequences

### 4.2.1 Types of Gambling

Wagering (sometimes simply called “betting”) is the most basic type of gambling, by which one party bets on the occurrence of an event and the other bets on its non-occurrence. People can wager not only on future events but also on things that have happened in the past.<sup>32</sup> In addition, people can also gamble by playing a game, which is generally called “gaming”. The game could be poker, dice, roulette etc., or even a sport. The outcome of the game might depend entirely on luck, or it might also partly rely on the skills of the players.

A variation of wagering is fixed-odds betting with a bookmaker. As with wagering, fixed-odds betting requires two parties: a punter and a bookmaker. The bookmaker publishes odds at which a punter may place a bet. Although largely used in sports betting, fixed-odds betting can apply to almost any event, as long as there is a market for bookmaking. While a bookmaker is usually a professional betting company, two non-professional individuals can also arrange fixed-odds betting. This would be the same as a bilateral “wagering” contract, except that the payoff under a fixed-odds betting scheme is not equal for both sides.

In the betting world, a “betting exchange” has now emerged to enable bookmakers and punters to “exchange” odds. For example, through “Betfair”, one of the most successful betting exchanges, a punter can either “back” or “lay” a bet. Backing odds is just the normal process of bookmaking, with the exception that a punter has a list of odds to choose from instead of a single one fixed by the bookmaker. For each “odds”, the Betfair shows the maximum amount that the punter can bet (i.e. to match another punter who provides the odds).

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<sup>32</sup> See Gambling Act 2005, section 9.

On the other hand, if a punter wants to bet on odds that are not currently provided by other punters (or on a larger amount), he can “lay” odds and wait for another punter to back. For example, if the current odds on England winning the World Cup 2010 are 9, 8.8, or 8.6, each available at 5,000 pounds and a punter wishes to bet 10,000 pounds at 9.2, this will be shown on the “lay” side. Any punter who wishes to back the 9.2 odds with 10,000 pounds can place his bet on the exchange (i.e. backing). The punter laying a bet is actually functioning like a bookmaker. If the layer loses the bet (say on 10,000 pounds), he has to pay 92,000 pounds to the backer(s). In contrast, if the layer wins, he earns 10,000 pounds from the backer(s).

Apart from wagering or bookmaking on the financial market, spread betting and so-called “bucket shop” transactions are typical examples of betting on the financial market. Spread betting allows a gambler to bet on an index, whatever the index is about.<sup>33</sup> As the name suggests, a spread betting company will offer a “spread”, a range on the index at which a gambler can buy or sell. To use an example given by Rix LJ:

“[I]f the Dow Jones index is, say, at 10,000, one can ‘buy’ or ‘sell’ the market at a spread around the index of, for the sake of example, 10 points either way, 9990 to 10010. If one buys, one is betting that the market will rise above 10010. If one sells, one is betting that the market will fall below 9990. If one buys and the market rises, one stands to gain £1 for every point that the index exceeds 10010. If one sells and the market falls, one stands to gain £1 for every point that the index drops below 9990. If, however, one calls the market wrong, then one will stand to lose £1 for every point that the index exceeds the spread point in the wrong direction. Thus if one sells at 10,000 with a sell spread point at 9990, one will make £1 for every point the market falls below 9990 and lose £1 for every point the market rises above 9990. Until the bet or ‘trade’ is closed, the gains and losses are merely ‘running’ gains or losses. They are real enough, but constantly changing with every change in the index, and have not yet been fixed. Closing the bet will fix the position, win or lose. Unlike a classic bet, the customer can of course lose more than his stake. Indeed, on the example given, of a sale spread point of 9990 when the market is at 10,000, if the market does not move an inch, the customer will lose £10 for every

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<sup>33</sup> Spread betting is similar to betting by contract of differences (CFD). One commentator distinguishes spread betting from a CFD on the ground that spread betting has a fixed expiry date but CFDs do not. See Ali, “Cyberderivatives: The Regulation of Online Trading in Equity Bets” (2006) 37 U Tol L Rev 439, at 446.



£1 staked. Nor, again unlike a classic bet, are his winnings fixed at the outset by an agreement on odds. In theory winnings based on rising markets are infinite (in practice of course they are not) and losses based on falling markets are limited only in so far as they cannot exceed the consequences of a fall in the index to zero.”<sup>34</sup>

The same structure can also apply to sports betting, with the index originating from a sports event (e.g. the number of runs in a cricket test) rather than from financial markets.<sup>35</sup>

Gambling can also involve multiple parties. In pool betting, each participant puts some money into a pool and the winners share all or part of the pool money.<sup>36</sup> Profits depend not only on the outcome of the bet but also on the number of winners. For example, assume that 50 punters each put £10 into a pool to bet on a horse race, and after deductions for costs, £480 remains in the pool. If only 10 punters pick the winning horse, each winner will earn £48 (£38 net gain). In contrast, if 30 people bet on the winner, the share will be reduced to £16 per person (i.e. only £6 net gain). Thus, pool betting is like gamblers betting with each other, which makes it difficult to analyse as a wager.<sup>37</sup> Pool betting on horse or dog races is called a “totalisator”.

To some extent, lotteries are similar to pool betting. In general, a participant must pay an amount of money as a stake and the distribution of prizes depends purely on chance. In more academic terms, a lottery can be either passive or active (i.e. if a player has an active role in drawing lots), and either exhausted (there must be at least one winner) or non-exhausted (there may be no winner).<sup>38</sup>

There are many other ways to gamble, such as gambling machines (e.g. slot machines) and bingo games. Casinos are more controversial. Casinos are different not only because they are places where people gather to gamble, but also

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<sup>34</sup> *Spreadex Ltd v Battu* [2005] EWCA Civ 855, at 1 (*per* Rix LJ).

<sup>35</sup> Sometimes a spread betting company might use some formula (e.g. each corner or free kick representing certain number of points) to convert straight statistics (e.g. the number of corners in a football match) into a spread/index.

<sup>36</sup> In France and in New York, pool betting is called a “*pari mutuel*”, which means “betting among ourselves”. Monkcom, Smith & Monkcom’s *Law of Betting, Gaming, and Lotteries*, at A0.09 note 1 (2nd ed., Butterworths, 2001).

<sup>37</sup> Monkcom, *id.*, at A0.11.

<sup>38</sup> Mier, *supra* note 6, at 127–128.

because casino operators act as banks for provide gambling games, receiving money from customers and paying cash to customers if they decide to cash in their stakes.<sup>39</sup>

## 4.2.2 Regulatory Aspect of Gambling

Before we introduce the current UK and US gambling laws, we should note that a variety of legal consequences attach to gambling or related conduct, ranging from civil unenforceability to criminal punishment. Some parts of gambling businesses might be regulated under a licensing scheme rather than being under a blanket prohibition. The regulation of gambling business provides us with another dimension for considering speculative notional transactions.

### 4.2.2.1 UK Law

The Gambling Act 2005 marked a dramatic turn in the history of UK gambling laws.<sup>40</sup> Under the Act, “gambling” generally refers to three categories of transaction: gaming, betting, and participating in a lottery.<sup>41</sup> Gaming is defined as “playing a game of chance for a prize”.<sup>42</sup> Betting means making or accepting a bet on the outcome of a race, competition, the likelihood of anything occurring or non-occurring, or whether anything is or is not true.<sup>43</sup> As to the enforceability of a gambling contract, the 2005 Act provides that “[t]he fact that a contract relates to gambling shall not prevent its enforcement”, and abolishes section 18 of the 1845 Act.<sup>44</sup> However, the Act also stipulates that this provision should

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<sup>39</sup> The Gambling Act 2005 provides that a casino is a place for people to participate in one or more casino games, which are defined as games of chance that are not “equal chance gaming”. Gaming is “equal chance gaming” if “it does not involve playing or staking against a bank” and the chances are equally favourable to all participants. See Gambling Act 2005, sections 7 & 8.

<sup>40</sup> For the development of the UK law and a general explanation of the new regime, see generally Light, “The Gambling Act 2005: Regulatory Containment and Market Control” (2007) 70(4) MLR 626.

<sup>41</sup> Gambling Act 2005, section 3.

<sup>42</sup> *Id.*, section 6.

<sup>43</sup> *Id.*, section 9. Section 16 determines which type applies when a transaction falls within both section 6 (gaming) and section 9 (betting).

<sup>44</sup> Gambling Act 2005, section 335(1).

not disrupt the application of the common law if the contract is found to be unlawful for other reasons.<sup>45</sup>

Fixed-odds betting and bookmakers are currently regulated in the UK. Under the Gambling Act 2005, from 1 September 2007 a person who provides facilities for fixed-odds betting must apply for a licence from the Gambling Commission. Failure to do so also constitutes a criminal offence.<sup>46</sup> Those who want to promote pool betting and lotteries should also apply for a licence from the Gambling Commission.<sup>47</sup> The new Gambling Act 2005 recognises the existence of betting exchanges and regulates them as “betting intermediaries”.<sup>48</sup> Casinos are also regulated.<sup>49</sup>

The regulation of spread betting is more complicated. Before the 2005 Act, spreading betting companies also held a bookmaker’s permits. The Gambling Act 2005 eliminates this dual regulatory structure and the Financial Services Authority (FSA) is now the only regulator for spread betting, in accordance with the Financial Services and Markets Act 2000 (FSMA 2000).<sup>50</sup> In fact, the Gambling Act 2005 does not really define “spread betting”. Instead, the Gambling Act 2005 excludes from the meaning of “betting” transactions that fall within the scope of the FSMA 2000.<sup>51</sup> Therefore, if a transaction is a regulated activity, that transaction is not treated as betting under the Gambling Act 2005.

#### 4.2.2.2 US Law

In the US, the law varies state by state. In this section, we will briefly introduce gambling laws in the States of New York and Illinois, home of the two biggest financial centres (New York City and Chicago respectively) in the US. The

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<sup>45</sup> Gambling Act 2005, section 335(2).

<sup>46</sup> Gambling Act 2005, section 33.

<sup>47</sup> Gambling Act 2005, section 33 (pool betting), and Part 11 and Schedule 11 (for lotteries). See also Gambling Act 2005, Part 10 (gambling machines); Gambling Act 2005, section 19 (bingo).

<sup>48</sup> Gambling Act 2005, section 13.

<sup>49</sup> See Gambling Act 2005, sections 7, 90, 168, 174-175 & Schedule 9.

<sup>50</sup> Gambling Act 2005, section 10(1). However, even if a transaction is not considered as a regulated activity under the FSMA 2000, the Gambling Act 2005 might still apply. See section 10(2). See also *City Index Ltd v Leslie* [1992] QB 98; *City Index Ltd v Stevenson* 2001 WL 1612618

<sup>51</sup> Gambling Act 2005, section 10(1).

Constitution of the State of New York provides that “no lottery or the sale of lottery tickets, pool-selling, book-making, or any other kind of gambling ... shall hereafter be authorized or allowed within this state”.<sup>52</sup> The New York penal code states the following:

“A person engages in ‘gambling’ when he stakes or risks something of value upon the outcome of a contest of chance or a future contingent event not under his control or influence, upon an agreement or understanding that he will receive something of value in the event of a certain outcome”.<sup>53</sup>

Promoting gambling is a crime.<sup>54</sup> New York law also provides that “[a]ll wagers, bets or stakes, made to depend upon any race, or upon any gaming by lot or chance, or upon any lot, chance, casualty, or unknown or contingent event whatever, shall be unlawful.”<sup>55</sup>

In contrast, the State of Illinois’s criminal code has a general prohibition against gambling. Playing “a game of chance or skill for money or other value” and “[making] a wager upon the result of any game, contest, or any political nomination, appointment or election” are both forms of illegal gambling, as is bookmaking.<sup>56</sup> Gambling contracts were also rendered null and void in Illinois law.<sup>57</sup> In both states, gambling may be allowed within a limited scope, usually under a licensing scheme.<sup>58</sup>

Betting on the financial markets is frequently called a “bucket shop” transaction in the US. Although the definition of “bucket shop” might vary from state to

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<sup>52</sup> NY Constitution, Article 1, section 9(1).

<sup>53</sup> NY CLS Penal 225.00(2).

<sup>54</sup> NY CLS Penal 225.05 and 225.10.

<sup>55</sup> NY CLS Gen Oblig 5-401. The winner of a wager cannot recover the money from the loser. See Bamman v Erickson, 41 NE 2d 920 (1942).

<sup>56</sup> 720 ILCS 5/28-1(a). In Illinois law, a person engages in bookmaking when he receives or accepts more than 5 bets or wagers of which the size exceeds \$2,000. 720 ILCS 5/28-1.1(d). See also People v Dugan, 485 NE 2d 315 (1985). The limit on the number of participants and the \$2,000 dollars requirement is in line with federal criminal statutes against illegal gambling businesses. See 18 USCA 1955.

<sup>57</sup> 720 ILCS 5/28-7.

<sup>58</sup> For example, Illinois has the Bingo Licenses and Tax Act, the Illinois Lottery Law, and the Raffles Act, etc. to allow certain bingo, lotteries or games to be immune from the criminal sanctions on gambling. See 720 ILCS 5/28-1. In New York, see NY CLS Racing & Wagering 102 *et seq.*

state, in general it means an off-exchange transaction to buy or sell a commodity or stock that is settled in cash rather than physical delivery. New York law defines a “bucket shop” as “any building, or any room, apartment, booth, office or store therein or any other place where any contract prohibited by this article is made or offered to be made”.<sup>59</sup> As this definition suggests, the bucket shop originates in off-exchange booths or shops that provided punters with a place to bet on the financial market. These bets used public market quotations published by an exchange as a benchmark, and bucket shops allowed punters to bet in the form of off-exchange futures contracts. In Illinois, a person who makes such a cash-settled contract commits the crime of gambling unless he satisfies the state law registration requirement.<sup>60</sup> New York law also makes sales not involving a *bona fide* purchase a felony.<sup>61</sup> Apparently, the anti-bucket shop laws are broad enough to have an impact on the legitimate financial market. The US Congress has exempted contracts falling within the ambit of the Commodity Exchange Act (CEA) from state bucket shop laws.<sup>62</sup>

In New York, a lottery must be operated by the State government and *pari mutuel* betting is allowed only on certain horse races. Otherwise, it is unlawful.<sup>63</sup> In Illinois, setting up and promoting a lottery and selling pools constitute the crime of “gambling”.<sup>64</sup> However, lottery, pool betting or bingo games might be allowed in a limited scope.<sup>65</sup>

In sum, there are several types of gambling, including wagering, gaming, pools, lotteries and the use of machines; each type has varying legal consequences. Gambling itself can be a crime, as in Illinois. Even if gambling attracts only

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<sup>59</sup> NY CLS Gen Bus 351-d (2005). The phrase “this article” refers to Article 23 of the General Business Law (of New York), the title of which is “Bucket Shops”.

<sup>60</sup> 720 ILCS 5/28-1(a)(4).

<sup>61</sup> NY CLS Gen Bus 351.

<sup>62</sup> 7 USCA 16(e)(2); see also 15 USCA 78bb(a) (the Securities Exchange Act of 1934).

<sup>63</sup> NY Const Article 1, 9(1); NY CLS Gen Oblig 5-401. See also *Shillitani v Valentine*, 71 NE 2d 450 (1945).

<sup>64</sup> 720 ILCS 5/28-1(a)(6)-(9).

<sup>65</sup> See 20 ILCS 1605/1 *et seq.* There is another Raffles Act. See 230 ILCS 15/0.0 (2005) *et seq.*; Illinois Horse Racing Act of 1975, 230 ILCS 5/1; the Bingo License and Tax Act, 230 ILCS 25/1 *et seq.* In New York, see NY Const Article 1, 9(2).

civil unenforceability, some activities related to gambling can be penalised. In addition, the UK Gambling Act 2005 has created a new age of gambling law by putting gambling transactions (especially commercial gambling) under a licensing regime rather than a straightforward prohibition. It might be an innovation for such a broad licensing scheme to cover the whole gambling industry, but licences were already in use in both the UK and the US. It is a matter of degree of control. The lack of consensus in dealing with “gambling” as a whole will influence where notional transactions should fall in the existing legal concepts.

### 4.3 Evils of Gambling and Speculation

It is necessary to understand why gambling is prohibited or regulated. To fully analyse the relationship between notional derivative instruments and gambling, we have to discuss not only definitional issues but also public policy implications behind gambling laws. It is easy to take the evils of gambling for granted. Gambling does not attract opposition merely because some people take a chance and make a windfall; there must be other reasons supporting anti-gambling laws. In fact, contracts relating to gambling were valid and enforceable in England until the Gaming Act 1710, which made security given for money won by gaming (or repayment of loan lent for gaming) void. Indeed, gambling has existed for centuries. Several pieces of legislation have been introduced in the UK to address various aspects of gambling problems, and the Gambling Act 2005 marked another milestone in the development of gambling policy.<sup>66</sup>

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<sup>66</sup> To name a few others, past legislation includes the Gaming Act 1710, the Gaming Act 1845, the Betting Act 1853, the Street Betting Act 1853, the Gaming Act 1892, the Street Betting Act 1906, the Ready Money Football Betting Act 1920, the Racecourse Betting Act 1928, the Betting and Lotteries Act 1934, the Pool Betting Act 1954, the Small Lotteries and Gaming Act 1956, the Betting and Gaming Act 1960, the Betting Levy Act 1961, the Betting, Gaming and Lotteries Act 1963, the Gaming Act 1968, the Lotteries and Amusements Act 1976, the Betting and Gaming Duties Act 1981, the Gaming (Bingo) Act 1985, and the National Lottery Act 1993. During the past 60 years, at least two Royal Commissions (in 1949-1951 and in 1976-1978) were formed to investigate gambling in the UK in addition to a Home Office report in mid-1970s. This thesis will not recount the full history of the development of gambling laws in the UK.

The most intuitive response to gambling is based on moral judgment.<sup>67</sup> Gambling could be described as an opportunistic and non-productive behaviour that may be linked to greed, waste of money and laziness as opposed to virtues such as thrift and diligence.<sup>68</sup> In New York, the penal law places gambling in the category of “offenses against public health and morals”.<sup>69</sup> While we need not seek to justify or disapprove of these underlying moral values, we should recognise that they may be open to debate in any given society at a specific time. It is also highly unlikely that a single moral value would be applied universally.

Apart from general moral theory, one primary concern with gambling is its association with crime. Whether gamblers deserve criminal penalties is another matter. Moreover, there is a serious concern that gambling can lead to other crimes or, to a lesser extent, a breach of a person’s fiduciary or other duties.<sup>70</sup> One of the licensing objectives of the Gambling Act 2005 is to “[prevent] gambling from being a source of crime or disorder, being associated with crime or disorder or being used to support crime”.<sup>71</sup>

It is true that gambling has a long courtship with other kinds of crime and criminal organisations. The Illinois statute clearly recognises “the close relationship between professional gambling and other organized crime” in its prohibition of “syndicated gambling” (in short, professional gambling).<sup>72</sup> However, whether gambling really leads to more crimes requires more empirical study. It has been argued that gamblers can quickly accumulate debts and the pressure for money can lead them to committing crimes (e.g. embezzlement) in order to procure more money to continue gambling or repay gambling debts,

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<sup>67</sup> See Hurt, “Regulating Public Morals and Private Markets: Online Securities Trading, Internet Gambling, and the Speculation Paradox” (2006) 86 BU L Rev 371, at 395; Pickens, “Of Bookies and Brokers: Are Sports Futures Gambling or Investing, and Does It Even Matter?” (2006) 14 Geo Mason L Rev 227, at 242; Mier, *supra* note 6, at 5 & 8.

<sup>68</sup> Aranson & Miller, “Economic Aspects of Public Gaming” (1980) 12 Conn L Rev 822, at 835. One may even argue that gambling may have regressive effect on a person’s income, particularly when one is poor. Aranson & Miller, at 836 *et seq.*

<sup>69</sup> See NY CLS Penal 225.00 *et seq.*

<sup>70</sup> See for example, in *Charter plc v City Index Ltd* [2006] EWHC 2508, when a director stole the company’s properties to compensate for his own gambling debt.

<sup>71</sup> Gambling Act 2005, section 1(a).

<sup>72</sup> 720 ILCS 5/28-1.1(a). See also Cornish, *Gambling: A Review of the Literature*, at 74–75 (HMSO, 1978); Aranson & Miller, *supra* note 68, at 847 *et seq.*

which may justify the civil unenforceability of gambling contracts or security associated with gambling.<sup>73</sup> However, if gambling debts are not enforceable by courts, it is not surprising that a creditor might adopt illegal measures to collect his debt. Arguably this policy might increase the chance of crimes being committed.

In 1951, a Royal Commission concluded that “[w]e do not doubt that there is not uncommonly a connection to be found between dishonesty and excessive gambling in persons of a generally dissolute character, but we should not regard this as evidence that gambling is, in itself, a cause of crime.”<sup>74</sup> This is a rather interesting statement, using double negatives to express its concern, yet producing no convincing evidence. Nevertheless, the link between gambling and other crimes still appeared to be a major worry for the UK government when it drafted the later Gambling Act 2005.<sup>75</sup>

Public order is another consideration for the government. The use of the term “disorder” alongside “crime” in the Gambling Act 2005 indicates that the “disorder” in section 1 refers to more than criminal conduct. A disorder may derive from the impact of gambling on surrounding persons, or it may originate from gambling in public places. While gambling for leisure in private homes may be free from sanction, gambling in public places is obviously a target of the gambling laws.<sup>76</sup> A significant part of gambling regulation or prohibition is meant to control gambling premises.<sup>77</sup>

Excessive gambling also attracts much attention as some people become addicted to gambling as others do to drugs or alcohol. In turn, the addiction can have a derivative impact on the gambler’s family or environment.<sup>78</sup> This situation is

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<sup>73</sup> See Cornish, *id.*, at 66–71.

<sup>74</sup> Report of the Royal Commission on Betting, Lotteries and Gaming, 1949-1951 (Cmd 8190, HMSO), at 52; quoted from Cornish, *supra* note 72, at 68.

<sup>75</sup> See Gambling Act 2005, section 1(a).

<sup>76</sup> For example, the Street Betting Act 1853, the Street Betting Act 1906, and the Betting, Gaming, and Lotteries Act 1963, section 8.

<sup>77</sup> For example, the Gambling Act 2005, section 37 and Part 8.

<sup>78</sup> For example, it has been reported that President Truman once grumbled about his father’s having cancelled his son’s childhood piano classes because he had lost a lot of money speculating on grain trading. See Markham, *The History of Commodity Futures Trading and Its Regulation*, at 6 (Praeger, 1987).



not helped by the fact that commercial gambling businesses may try to induce people to continue gambling. The vulnerability of youngsters and children also raises serious concerns: one of the licensing objectives of the Gambling Act 2005 is to “[protect] children and other vulnerable persons from being harmed or exploited by gambling.”<sup>79</sup> A more interesting question is to what extent we should protect companies from “gambling”. Company managers might also be lured by potential profit to over-speculate when making decisions. A company might be as vulnerable as a natural person.

The evils of gambling are not limited to the punter himself or those people around him. Gambling may also bring disrepute to the game itself. “Cheating” is the most basic form. It may endanger the integrity of a sport when a punter bribes a player or manager to fix the result of a sporting event.<sup>80</sup> Ensuring a fair and open game is one of the licensing objectives of the Gambling Act 2005.<sup>81</sup> It is also interesting to compare the position in gambling law with that in insurance or securities law. In insurance law, several doctrines (such as good faith, indemnity, and insurable interest) have been developed to combat the possibility of “moral hazard”.<sup>82</sup> In securities law, there are comprehensive laws on insider trading and market manipulation.<sup>83</sup> We will discuss these issues in more detail in the next chapter.

After illustrating several of the evils of gambling, we must ponder whether gambling has any positive value. Gambling is now a global business; indeed, it is a big moneymaking machine.<sup>84</sup> For example, lotteries have a long history as

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<sup>79</sup> Gambling Act 2005, section 1(c).

<sup>80</sup> An infamous example is the “Black Sox” scandal involving the Chicago White Sox team in 1919 in the US. An ex-player used his connections and money to bribe eight players to “fix” the result of the World Series that year. A complex web of financing surrounded the conspiracy so that the “fix” could hardly be kept secret. Eventually, the eight players were indicted.

<sup>81</sup> Gambling Act 2005, section 1(b).

<sup>82</sup> In the context of insurance, moral hazards mean behaviour on the part of the insured to change or increase probability of loss (or the size of it) after a policy is issued. *See* Cooter & Ulen, *Law and Economics*, at 50 (3rd ed., Addison-Wesley, 2000).

<sup>83</sup> *See* Financial Services and Markets Act 2000, section 118; *see also* Rule 10b-5 of the Securities and Exchange Commission in the US.

<sup>84</sup> Even two decades ago, gambling was already big business. *See* Cornish, *supra* note 72, Chapter 3. The Rothschild Royal Commission also discovered that the annual turnover of the whole gambling business in Britain was in excess of £ 8,000 million at the end of 1970s. Rothschild, “The Royal Commission on Gambling” (1983) 26 (5) *American Behavioral Scientist*

fund-raising tools, and the UK's National Lottery has raised a substantial amount of money for the arts.<sup>85</sup> Sometimes a government operates a lottery to finance a war or other public activities.<sup>86</sup> Similarly, in the US, casinos are sometimes allowed in order to boost the local economy (e.g. Las Vegas in Nevada) or to support minority groups (e.g. casinos operated by Native Americans in California). Moreover, gambling can be a type of leisure activity. It may not be possible to translate the emotional value of gambling into monetary terms, but it is valuable in a utilitarian sense.<sup>87</sup> This does not mean that gambling, if used in such positive way, suddenly becomes a morally good thing. However, if we look at the big picture, the gambling business and a certain degree of speculation might produce more good than bad for a society.

It is necessary to note that market speculation (and, to a certain extent, investment) might share similar problems with traditional gambling.<sup>88</sup> First, speculation on the market can quickly bankrupt a person or a business (e.g. the Barings Bank scandal).<sup>89</sup> Given that derivative instruments are inherently risky (see section 2.2.2.5 above), it is not a remote possibility that the user of derivative instrument might easily accumulate huge debt that could lead to insolvency or a similar kind of derivative effect on other related persons (e.g. the shareholders of a company). Moreover, a person might speculate excessively in the financial market (like excessive gambling), and this monetary effect could then lead to proprietary crimes. It is not inconceivable that a person may use derivative instruments to commit white-collar crime (e.g. insider dealing; see section 5.5

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569, at 569. It is also estimated that the national gambling turnover in the UK was about 20 billion pounds in 1995. Miers, "Regulation and Public Interest: Commercial Gambling and National Lottery" (1996) 59 (4) MLR 489.

<sup>85</sup> According to its website, the National Lottery has so far raised 18 billion pounds for causes such as art, sport, heritage, etc. See <<http://www.national-lottery.co.uk/player/p/goodcauses/fundraising.do>> (visited on 20 October 2006).

<sup>86</sup> For example, in 1612 a public lottery was promoted to finance the colonisation of Virginia. See Mier, *supra* note 6, at 130.

<sup>87</sup> Some argue that gambling is a kind of consumer goods that can create utility (but which might not be quantified in monetary terms). See Aranson & Miller, *supra* 68, at 835. See also Hurt, *supra* note 67, at 379 *et seq.*

<sup>88</sup> It will be discussed later whether market speculation can be distinguished from gambling because will be discussed later. See *infra* 4.4.1.

<sup>89</sup> See Pickens, *supra* note 67, at 249 *et seq.*

below). A more serious result of excessive speculation is the so-called “systemic risk” that may jeopardise the health of the financial market.<sup>90</sup>

Secondly, speculation (or over-speculation) on the market may distort market prices (see also section 3.3.4.1 above). This issue is not remote from notions of fairness with respect to games, which may explain why market speculation is not always welcome in the financial market. The history of the US Commodity Exchange Act also reflects a bias against market speculation.<sup>91</sup>

Thirdly, whether market speculation merits moral condemnation depends on one’s point of view. Hidden behind all the jargon and numbers might lie market participants’ greed for profit; even worse, market speculation is largely a rich men’s game that makes the rich even richer. Market speculation is no less worth being condemned on moral ground than gambling with traditional gambling instruments, at least from a poor man’s view.

In contrast, while gambling attracts much criticism, judges seem to take “hedging” as a legitimate commercial purpose.<sup>92</sup> And risk reduction might be seen as a morally good thing.<sup>93</sup> The long history of insurance law suggests that minimising the impact of loss originating from a future event is acceptable. Perhaps what many people dislike most is the opportunistic nature of typical “gambling” conduct. Thus, if a transaction does not fall into this traditional trap, it is vindicated. While traditional gambling conduct does not produce goods or

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<sup>90</sup> To quote Hudson’s words, systemic risk “is the risk that if one sufficiently large market participant were to go into insolvency that would have the effect of putting sufficient pressure on other market participants to whom the insolvent party owed money that those other market participants would similarly go into insolvency, with a further effect on yet more market participants with whom that second tier of insolvent entities had dealings.” Hudson, *Law on Financial Derivatives*, at 13-02 (4th ed., Sweet & Maxwell, 2006).

<sup>91</sup> See Stout, “Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives” (1999) 48 *Duke LJ* 701, at 721 *et seq.*

<sup>92</sup> In *City Index Ltd v Leslie* [1992] QB 98, Leggatt LJ stated that “[a]lthough before the [1986] Act came into force, contracts for differences were void, other contracts which are superficially similar were not. These were contracts entered into for a commercial purpose, such as hedging. Such contracts may result in no more than the payment of a difference. But because they were made for a commercial purpose, they are not void as wagering contracts.” At 112. For New York law, see also *Holberg v Westchester Racing Association*, 53 *NYS 2d* 490 (1945).

<sup>93</sup> Rescher, “Risk: A Philosophical Introduction to the Theory of Risk Evaluation and Management”, at 162 *et seq.* (University Press of America, 1983).

services for exchange (and is thus non-productive), hedging and insurance, by contrast, does help to reduce the risk exposure of a person.<sup>94</sup>

From the above discussion, we may conclude that gambling and market speculation by way of modern risk trading or investment instruments might lead to similar problems. It would be naïve to assume that gambling is always bad and market speculation is always good. Even gambling may be justified in certain circumstances (though not necessarily made invulnerable to moral critique). In contrast, speculation, the existence of which might be necessary for a sound financial market, requires further consideration. Thus, what matters is identifying potential problems and forming a consistent line of policy behind laws relating to different (but possibly similar) instruments. This thesis will pursue the analysis on this basis.

## **4.4 Distinction from Gambling Contracts: An Analytical Structure**

The need to justify or to distinguish a certain transaction from gambling comes from the fact that a gambling contract may be unenforceable or a person operating a gambling business may be penalised or regulated. In the following sections, we will first provide certain conceptual arguments to distinguish gambling from other transactions. We will also make reference to insurance contract law to see whether it is possible to extend the insurable interest test to notional risk trading contracts. Furthermore, we will consider the identity of contractual parties and discuss what we should do to speculative transactions in different contexts.

### **4.4.1 Certain Conceptual Arguments**

It is interesting to start with certain conceptual arguments to separate gambling contracts from derivatives, hedging or speculation. The purpose of this section

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<sup>94</sup> However, the economic efficiency and social value of derivatives to society may still open to academic debate. See Huang, “A Normative Analysis of New Financially Engineered Derivatives” (2000) 73 S Cal L Rev 471; Stout, *supra* note 91.

is to examine these arguments to help us to understand the nature of both gambling and notional instruments. We will argue that derivative instruments, if used for speculation, are indeed a form of gambling by nature.

First, a straightforward argument is that derivative instruments are used for hedging, but that gambling is purely speculative. An interesting correspondence in the Financial Times may serve as an example. On May 2006, the Lex column of the Financial Times introduced its readers to the “variance swap”, a product for measuring the volatility of markets.<sup>95</sup> The journalist stated that “[a] prolonged period of calm has encouraged hedge funds to bet that equity volatility would remain low.”<sup>96</sup> Interestingly, a few days later, a finance professor from the US wrote a letter to the Financial Times and stated that “Lex’s lucid explanation of the mechanics of variance swaps was slightly marred by the word ‘bet’”, continuing

“[v]ariance swaps serve a valuable role for many market participants; they are not just esoteric instruments of speculation. Hedge funds find it harder to make money in calm markets. Hence, their selling variance swaps is not so much a bet on markets remaining calm as (most appropriately) a hedge against this.”<sup>97</sup>

This correspondence reflects that the term “betting” has been stigmatised. It is granted that a variance swap might be used to hedge against the volatility (or lack of volatility) of the market. However, the correspondence ignores the fact that the same transaction could also be used for pure speculation (i.e. a bet on the volatility of the market). In short, a notional transaction might be used for hedging or other legitimate purposes, but the nature of cash settlement also means it may become a purely speculative vehicle. Several UK judges have also accepted that an interest rate swap could be used for commercial purposes as well

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<sup>95</sup> A variance swap is based on the magnitude of the volatility of market prices or indices. Both parties agree upon a strike level of volatility (in the form of percentage points) and the pay-off under the variance swap is determined by the differences between the square of the strike level and the square of the actual level of volatility in the settlement period, based on a notional amount. See Das, *Structured Products Volume 1: Exotic Options; Interest Rates & Currency*, at 483-484 (3rd ed., rev edn, John Wiley & Sons, 2006).

<sup>96</sup> “Lex: Volatility” Financial Times (24 May 2006).

<sup>97</sup> “Letter to the Editor: These Swaps More a Hedge than a Bet” Financial Times (29 May 2006).

as for speculative purposes.<sup>98</sup> It is not wise to emphasize the hedging function of the transaction while overlooking the speculative application of an instrument.

Secondly, if we confine the discussion to hedging transactions, we can try to distinguish the subject matter of hedging and traditional gambling instruments. “Hedging” is usually linked with “risk”, while “gambling” is frequently described as playing a “game of chance”. One may further argue that an uncertainty in a game of chance causes no harm, while in a hedging transaction a person is exposed to potential loss if the risk is realised.<sup>99</sup>

Whatever the words may suggest, risks and games of chance both involve uncertainties. It is because of the uncertainty of future events that people can gamble to make money.<sup>100</sup> The literal meaning of “chance” provides no further guidance; in fact, the “chance” (or possibility) that market price will move up or down is exactly what we describe as a “price risk”. Indeed, like hedging risks, most gambling deals with future uncertainties. If we adopt this view, taking a market risk and playing a game of chance are the same ideas under different descriptions.

It is true that the outcome of some games (e.g. a lottery) depends purely on luck. For these games or gambling instruments, a punter intentionally exposes himself to an extra risk that should, in theory, be beyond anyone’s control. However, the payoff of a gambling instrument could be due to the result of an external factor. The uncertainty of a bucket shop transaction based on the FTSE 100 Index is the same as that of a derivative instrument (e.g. an option) on the FTSE 100 index.

Moreover, it is not true that sports cannot lead to harm beyond an emotional level. The owner of a horse might have some incentive to compensate for his loss

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<sup>98</sup> See *Hazell v Hammersmith and Fulham London Borough Council* [1992] 2 AC 1, at 23-25 (per Lord Templeman); *Morgan Grenfell & Co Ltd v Welwyn Hatfield District Council* [1995] 1 All ER 1, at 7-8 (per Hobhouse J); *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669, at 680 (per Lord Goff).

<sup>99</sup> Aranson & Miller, *supra* note 68, at 834 (citing King, *Gambling and Organized Crime*, at 17 (1969)).

<sup>100</sup> While it is not usual that people will hedge a loss from a past event, one extra dimension of gambling is that people can actually gamble on past events. It is arguable whether an uninformed party can place a hedge even if a risk has crystallised or a peril is sure to have come into existence. However, gambling and hedging can by no means be distinguished merely on the possibility of dealing with past uncertainties.

should the horse not win a race. Thus, a horse owner might actually “hedge” his potential loss (e.g. future value of breeding) by placing bets with a bookmaker. A punter who places a bet on a sporting event may also hedge his bet simply by making a contrary bet.<sup>101</sup> Thus, it is not convincing to argue that the uncertainty (or risk) of a traditional gambling transaction can cause no other harm.

Thirdly, another discernible difference between hedging and gambling is that by hedging, a person is exchanging uncertainty in return for certainty, while by gambling a punter actively and intentionally increases his own risk of loss. This description probably applies to certain types of behaviour, but it does not provide a defining line for the notional transaction, especially since notional transactions could be used for pure speculation other than hedging. In addition, hedging is itself frequently a risky transaction (see section 2.2.2.5 above). One may have to take extra risks in order to hedge another transaction; by exporting an uncertainty, another uncertainty might take its place.

Fourthly, another theory distinguishes “speculation” from “gambling”.<sup>102</sup> The reason is that speculation can help to make the market while gambling cannot.<sup>103</sup> Indeed, there must be at least two parties to make a transaction, and it might be costly for a hedger to find another hedger to meet his demands.<sup>104</sup> Speculators might fill in the role and make the market.<sup>105</sup> This theory particularly applies to the financial or commodity markets.<sup>106</sup> However, with the help of betting

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<sup>101</sup> A bookmaker who receives bets from punters can place a bet in a betting exchange or with another bookmaker (a hedging bet) so as to shift his risk exposure from the punters’ bets to the other party. This situation is somewhat similar to the reinsurance market or back-to-back swaps. See Mier, *supra* note 6, at 6, note 23.

<sup>102</sup> We should be aware that some commentators prefer to use “speculation” as an umbrella term to cover gambling, market speculation and other speculative behaviours. For example, see Stout, *supra* note 91; Hurt, *supra* note 67.

<sup>103</sup> Mier, *supra* note 6, at 6-7.

<sup>104</sup> See Clark, “Genealogy and Genetics of “Contract of Sale of a Commodity for Future Delivery” in the Commodity Exchange Act” (1978) 27 Emory LJ 1175, at 1205–1208; Hazen, “Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance” (2005) 24 Ann Rev Banking & Fin L 375, at 436; Bianco, “The Mechanics of Futures Trading: Speculation and Manipulation” (1977) 6 Hofstra L Rev 27, at 30 *et seq.*

<sup>105</sup> See Das, *Derivative Products & Pricing*, at 654 *et seq* (3rd ed., rev edn, John Wiley & Sons, 2006).

<sup>106</sup> Aranson and Miller distinguish insurance, speculation and gambling as the three forms of activities with explicit assessment of risk. They seem to compare “speculation” with the kind of

exchanges, a bookmaker can also hedge his own risk or make the odds market by betting with another bookmaker.<sup>107</sup> Arguably, a bookmaker in this situation acts like a market maker in the betting market in this situation; he can provide a bridge between two punters.

Moreover, speculation, though necessary in the market, may be prohibited beyond a certain limit.<sup>108</sup> Speculation on the market might also raise concerns about distortion of market prices.<sup>109</sup> Thus, it is not convincing to distinguish speculators and gamblers in their market-making function; after all, speculation in the market and gambling on financial markets are both opportunistic transactions that profit from market fluctuation. How much speculation is tolerable requires deeper analysis.<sup>110</sup>

In sum, any attempt to conceptually distinguish gambling and notional derivative transactions might succeed in some aspects but must fail in others—an unavoidable result given the variety of types of gambling and the uncertainty surrounding what gambling really means. Thus, we may come to the conclusion that both traditional gambling instruments and derivative instruments are capable of being used to make speculative profits, and thus they are aleatory in nature.

As the above discussion indicates, a better distinction between traditional gambling instruments and notional transactions might depend on the relationship between the stakeholder and the potential loss. It is gambling if a punter who has no relationship with the horse decides to make a profit on horse racing betting. It might be “hedging” if the owner of the horse decides to “insure” his potential loss (e.g. the drop of value of the horse) should the investment on the horse be in vain. Both of the above transactions depend on the occurrence or non-occurrence of an event (the horse’s winning the race).

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risk-taking activities in the futures market. Apparently, the meaning of “speculation” is more limited if we confine it to the futures market. *Supra* note 68, at 831, 833–835.

<sup>107</sup> *See supra* note 101.

<sup>108</sup> For example, the Commodity Exchange Act prohibits trading or positions in excess of limits fixed by the CFTC. 7 USCA 6a.

<sup>109</sup> Stout, *supra* note 91. *See also supra* 3.2.4.

<sup>110</sup> *See generally*, Stout, *supra* note 91.



Perhaps it is better to argue that we see some instruments as “gambling” in accordance with how the general public perceives certain types of behaviour and how a party uses a particular transactional structure to achieve his goals. We cannot easily categorise a transaction merely by its name, its structure, or the source of the uncertainties involved. We must examine the purpose of the transaction, the intention of the parties and/or the proprietary links to distinguish “gambling” from other purposes, rather than relying on one single “description” of a certain class of activities.

#### 4.4.2 Reference from Insurance Law: Insurable Interest

The development of insurance law provides us with a useful guide. Wagering continues to be a major concern in the discussion of insurable interest.<sup>111</sup> If the insurable interest test could be taken as a way to identify policies for real insurance, it might provide a lesson on how to distinguish legitimate notional transactions from gambling. There is a lengthy list of cases regarding insurable interest that this thesis cannot recount in full detail. However, we should be aware that an English court has already argued that “insurable interest should bear as nearly as possible the same meaning for all categories of insurance.”<sup>112</sup> In *Feasey v Sun Life Assurance Co of Canada*,<sup>113</sup> Waller J provided a rather novel way of categorising insurable interests.<sup>114</sup> Waller J reorganised previous cases into four groups. Group (1) contains cases where the court has defined the subject matter as an item of property and the insurance is to recover the value of that property.<sup>115</sup> Group (2) includes cases where the court has defined the

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<sup>111</sup> The term “wager” or “wagering” was once used frequently in cases relating to insurable interests. For example, *see Wilson v Jones* (1867) 2 Ex 139, at 147; *Moran, Galloway & Co v Uzielli* [1905] 2 KB 555, at 563; *O’Kane v Jones (The “Martin P”)* [2004] 1 Lloyd’s Rep 389, at 417; *Feasey v Sun Life Assurance Co of Canada* [2004] CLC 237. However, we should be aware that it is wrong to assume that life insurance policies are wagering or gaming contracts. *See Feasey v Sun Life Assurance Co of Canada* 2003 WL 21353304, at 53–59 (*per* Waller LJ). *Cf.* Marine Insurance Act 1906, section 4.

<sup>112</sup> *Feasey v Sun Life Assurance Co of Canada* 2003 WL 21353304, at 174 (*per* Ward LJ).

<sup>113</sup> 2003 WL 21353304; [2004] CLC 237.

<sup>114</sup> *See* Birds, “Insurable Interest – Oxblood and Unorthodox Approaches” (2006) JBL 224, at 229.

<sup>115</sup> *Feasey v Sun Life Assurance Co of Canada* 2003 WL 21353304, at 80 (*per* Waller J).

subject matter as a particular life of a particular person and the insurance is to recover a sum on the death of that person.<sup>116</sup> Group (3) contains cases where the subject matter is an adventure and not merely a particular item of property.<sup>117</sup> Group (4) includes policies in which the court recognised interests that are not even strictly pecuniary.<sup>118</sup>

On this basis, we will proceed to our discussion. Upon first impression, derivative instruments are mostly related to insurance concerning property. However, as we have indicated in Chapter 2 (see 2.5.4 above), it is not impossible that derivative techniques might be applied to contracts about human lives. Thus, in the following two sections, we will arbitrarily discuss the issue of gambling and insurable interest in life assurance (i.e. Group (2) above) and in property insurance (Group (1) and (3) above).<sup>119</sup>

#### 4.4.2.1 Gambling and Life Assurance

The preamble of the Life Assurance Act 1774 clearly states that “[w]hereas it hath been found by experience that the making insurances on lives or other events wherein the assured shall have no interest hath introduced a mischievous kind of gaming.”<sup>120</sup> It has been commented that “[t]he paramount purpose of the 1774 Act was to stamp out gambling hidden by a notional insurance.”<sup>121</sup> Section 1 of the Act further states that

“no insurance shall be made by any person ... on the life or lives of any person or persons, ... wherein the person or persons for whose use, benefit, or on whose account such policy or policies shall be made, shall have no interest, or by way of gaming or wagering.”

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<sup>116</sup> *Id.*, at 82.

<sup>117</sup> *Id.*, at 87.

<sup>118</sup> *Id.*, at 90.

<sup>119</sup> The reader should bear in mind that the distinction in this thesis between life assurance and property insurance is based on the general perception of the insurance market and made for the convenience of discussion. This thesis does not argue that an insurance policy must be either life assurance or property insurance. Sometimes, whether an insurance policy is a life policy might be called into question. See for example *Fuji Finance Inc v Aetna Life Insurance Co Ltd* [1997] Ch 173.

<sup>120</sup> Preamble of the Life Assurance Act 1774.

<sup>121</sup> Merkin, “Gambling by Insurance: A Study of the Life Assurance Act 1774” (1980) 9 *Anglo-Am L Rev* 331, at 331.

Two points are worth discussion. First, life insurance contracts might be used as a form of wagering. The same is also true for non-life insurance, as it has been observed that “insurance is a contract upon speculation.”<sup>122</sup> Since payment under an insurance policy depends on the occurrence or non-occurrence of a future event, there is no doubt that insurance has a certain aleatory character like traditional gambling instruments.

Secondly, a careful reading of section 1 of the Life Assurance Act 1774 might suggest that whether a life policy is intended as wagering and whether there is an insurable interest in the policy are two different questions.<sup>123</sup> In *Feasey v Sun Life Assurance Co of Canada*,<sup>124</sup> the court returned to the meaning of “wagering” and section 1 of the 1774 Act. It was held that, even though a life policy was not one of indemnity, it did not remove the need to show insurable interest; and thus, the critical question was whether the person buying insurance had any interest in the life of the assured rather than whether a policy was a wagering contract.<sup>125</sup> Whether such an interest is enough to disrupt speculation on human lives is another matter. There might be some cases where a person could benefit from the imperfect insurable interest test and still speculate on a person’s life or death.<sup>126</sup>

Let us consider the reasons why we distinguish gambling from insurance policies. Moral hazard is apparently of relevance. Since an insurance policy hinges upon a future event, an assured might make a profit from the insurer’s lack of knowledge or control. In the case of a life insurance policy, where the life or death of a person is in stake, such a danger might be too insupportable, so requiring the person who buys a policy to have a certain relationship with the assured might to a certain extent reduce such danger. As was mentioned in Chapter 2, most derivatives have nothing to do with the life or death of a person.

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<sup>122</sup> *Carter v Boehm* (1766) 3 Burr 1905.

<sup>123</sup> In fact, wagering or gaming contracts were still enforceable at the time when the 1774 Act came into force.

<sup>124</sup> 2003 WL 21353304.

<sup>125</sup> *Id.*, at 59 (*per* Waller LJ) and at 151 (*per* Ward LJ; citing *Carlill v Carbolic Smoke Ball Co* [1892] 2 QB 484, at 491 (*per* Hawkins J) and *Dalby v The India and London Life Assurance Co* (1854) 15 CB 365, at 388 (*per* Parke B)).

<sup>126</sup> See generally Merkin, *supra* note 121.

Thus, the moral hazard concerns for life insurance policies are not currently relevant to derivative instruments. However, developing a derivative instrument that links profit to the pattern of human life and death is not unimaginable (see section 2.5.4 above). As long as derivative techniques are applied to the general life expectancies in a country (or region), such derivative instruments might not face the moral hazard concerns of a life insurance policy. However, if one day the same technique is applied to the life or death of a more specific individual or small group of persons, it might be the time to consider the insurable interest test of life insurance, because people might start to speculate on other person's lives.

#### **4.4.2.2 Insurable Interest in Property Insurance**

Since notional transactions deal largely with monetary loss, it is natural to compare them with property insurance. However, one of the problems in property insurance relates to the indemnity of property insurance.<sup>127</sup> We will examine some issues relating to information and moral hazards in the next chapter. For the present time, we will focus on the question of gambling and notional transactions.

What is an insurable interest? Section 5(2) of the Marine Insurance Act 1906 provides that

“a person is interested ... where he stands in any legal or equitable relation to ... any insurable property at risk therein, in consequence of which he may benefit by the safety or due arrival of insurable property, or may be prejudiced by its loss, or damage thereto, or by the detention thereof, or may incur liability in respect thereof.”<sup>128</sup>

In short, an insurable interest might be seen as an “insurable relationship”.<sup>129</sup>

In determining whether a person can insure against loss to a property, the most direct connection is the ownership, either legal or equitable. This constitutes the

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<sup>127</sup> See *supra* Chapter 2, note 45.

<sup>128</sup> See also Life Assurance Act 1774, section 1. A life policy without insurable interest is null and void.

<sup>129</sup> See Harnett & Thorton, “Insurable Interest in Property: A Socio-economic Re-evaluation of A Legal Concept” (1948) 48 Colum L Rev 1162; Clarke, Policies and Perceptions of Insurance: An Introduction to Insurance Law, at 20 (Clarendon, 1997).

so-called “legal interest” analysis, adopted by Lord Eldon in *Lucena v Craufurd*<sup>130</sup> and affirmed by *Macaura v Northern Assurance Co Ltd*<sup>131</sup> as the English authority. Under the legal interest test, the insured must be either the legal or equitable owner of the insured property. This test is not shared by other common law jurisdictions where a broader test than merely legal or equitable ownership is adopted.<sup>132</sup>

On the other hand, there is the so-called “factual expectancy” test, which was first proposed by Lawrence J in *Lucena*:

“To be interested in the preservation of a thing, is to be so circumstanced with respect to it as to have benefit from its existence, prejudice from its destruction. The property of a thing and the interest devisable from it may be very different: of the first the price is generally the measure, but by interest in a thing every benefit and advantage arising out of or depending on such thing, may be considered as being comprehended.”<sup>133</sup>

The result is that an assured needs only a commercially reasonable expectation to have a valid insurance policy, even though he is not an owner of that property. The difference in the shareholder’s case in insuring the company’s asset is apparent.<sup>134</sup> Some English judges have been more willing to adopt a broader insurable interest analysis than in *Macaura* but so far the strict legal interest test still stands firm as precedent.<sup>135</sup>

We could then consider whether it is possible to extend a similar line of analysis to notional transactions. As we will argue below, there is no particular reason to restrict notional transactions, if used for hedging purposes, to the function of indemnity. The term “hedging” covers a far wider scope of activities than mere

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<sup>130</sup> (1806) 2 Bos & PNR 269.

<sup>131</sup> [1925] AC 619.

<sup>132</sup> See generally, Lowry & Rawlings, “Re-thinking Insurable Interest” in Worthington (ed.), *Commercial Law and Commercial Practice*, at 347–354 (Hart, 2003).

<sup>133</sup> (1806) 2 Bos & PNR 269, at 302–3.

<sup>134</sup> Cf. *Macaura v Northern Assurance Co Ltd* [1925] AC 619 and *Constitution Insurance Company of Canada v Kosmopoulos* (1987) 34 DLR (4th) 208.

<sup>135</sup> For example, *Sharp v Sphere Drake Insurance plc (The “Moonacre”)* [1992] 2 Lloyd’s Rep 501 (sole shareholder has insurable interest in the yacht bought by the company). See generally, Lowry & Rawlings, *supra* note 132, at 354–360.

loss indemnification. These differences may mark the difficulties of applying the insurable interest test to other notional contracts.

We have to start with the legal interest test. The application seems natural because a transaction is very likely to be for hedging purposes if a person is the owner of a property. For example, a farmer might plan to hedge the price of the grain he grows on his farm. However, very frequently a person requiring a hedge does not own the property at all, especially when he wants to hedge against movement of the market or economy. Furthermore, hedging is frequently not about damage to a specific property but the value of something (in the form of market prices). If we expect a hedger to be the legal or equitable owner of a property, most of the current derivatives market would simply wither away. Thus, the legal interest analysis is too narrow to suit the world of hedging.

The factual expectancy test seems to be a better fit. A person requires a hedge because he expects potential loss from unrealised risks to his business. A pension fund, which has all 30 stocks in the Dow Jones Industrial Average (DJIA), has full incentives to hedge its portfolio by trading DJIA forwards. This “expectation” of loss justifies seeking hedging transactions. It is probably true to say that modern hedging is built upon expectations of future market movements or some such events.

Nevertheless, by comparison, we also find that the “factual expectancy” in property insurance is constructed on certain kinds of proprietary interest, if not as formal as legal or equitable ownership.<sup>136</sup> Thus, in a property insurance policy we can examine the expectation of the insured based on his interest in a certain property, project or contractual relationship.<sup>137</sup> In contrast, the same basis might not be applicable to modern hedging with notional transactions. While buying or selling futures for grain in the current season seems to fit reasonably well into

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<sup>136</sup> For example, in *Wilson v Jones* (1867) 2 Ex 139, the question was whether a shareholder could buy a policy to insure the trans-Atlantic cables owned by the company. Cf. the landmark Canadian case of *Constitution Insurance Company of Canada v Kosmopoulos* (1987) 34 DLR (4th) 208.

<sup>137</sup> For example, *Tomlinson (Hauliers) Ltd v Hepburn* [1966] AC 451 (cigarettes in a warehouse and the carrier); *Petrofina (UK) Ltd v Magnaload Ltd* [1984] QB 127 (subcontractor in a building project); *Mark Rowlands Ltd v Berni Inns Ltd* [1986] QB 211 (tenant un-named by the policy and building insurance).

the factual expectancy test, hedging next season's grain (or even the following season's), which might not have been seeded yet, looks more dubious. Virtually anything can be justified if the "factual expectancy" is drawn too broadly. This is not to say that some kind of "expectation" is not reasonable in application to non-insurance hedging contracts, as the expectation of a hedger is a key issue in determining whether a contract is intended for hedging. However, we should not ignore the underlying differences between a property insurance policy and its influence on formatting the factual expectancy test.

What is more revealing is the indemnifying nature of property insurance. A property insurance policy is used to indemnify the loss suffered by the insured if the insurance event occurs. If there is no loss, the insurer is under no obligation to pay; thus, the meaning of "loss" comes to the fore. The most straightforward meaning of "loss" is damage to property. However, damage can take a variety of forms. It may mean the cost of restoring a property to its original condition.<sup>138</sup> It may also mean a drop in value of the damaged property.<sup>139</sup> Loss of profit or economic loss can be claimed in the law of torts under certain conditions.<sup>140</sup> Price differences might be compensated if a buyer has to "cover" in the market or a seller has to resell in the market after a breach.<sup>141</sup> In addition, a party might claim for damage for psychiatric illness provided that certain conditions are met.<sup>142</sup> In insurance law, "loss" may not go as far as emotional damage, but may contain damage, expenses and loss of profit.<sup>143</sup>

In contrast, "loss" in notional transaction is different in certain regards. First, the so-called credit derivative comes closest to insurance or event-caused "loss".

<sup>144</sup> In a typical credit default swap (CDS), if the reference event occurs, the

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<sup>138</sup> See *Bacon v Cooper (Metals) Ltd* [1982] 1 All ER 397.

<sup>139</sup> The relationship between the costs to repair and the differences in value is not always an easy one. See *Ruxley Electronics and Construction Ltd v Forsyth* [1996] AC 344.

<sup>140</sup> See *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465.

<sup>141</sup> Sale of Goods Act 1979, sections 50 & 51.

<sup>142</sup> For example, *Page v Smith* [1996] 1 AC 155; *White v Chief Constable of South Yorkshire* [1999] 2 AC 455.

<sup>143</sup> For example, in *Wilson v Jones* (1867) 2 Ex 139, it was held that the policy was to insure against the profits to be derived from the success of the adventure (of laying trans-Atlantic cables).

<sup>144</sup> There has been some argument about whether a credit event in a credit derivative instrument should be material so as to deteriorate the credit of the reference entity. See *Deutsche Bank AG v*

risk-buyer has to pay for the loss in value of the reference obligation (e.g. a corporate bond) or simply to take delivery from the risk-seller on the par value (see section 2.2.2.3 above). This is similar to insurance because the liability of one party hinges upon the happening of an event. However, what differentiates a CDS from a credit insurance policy, a contract for guarantee or a security interest is that payment in a typical CDS refers to the differences between the par value and the market price of the reference obligation (e.g. the face value of a bond and its current market price) rather than the unpaid obligation of the principal debtor. Therefore, the concept of “loss” is still the key to determining whether a CDS can be defined as an insurance contract (see also section 2.5.3 above). (The difference is made clearer if we take a basket CDS into account rather than a “single name” CDS.<sup>145</sup>)

Secondly, in the hedging world, “loss” frequently means mere price differences. “Loss” might be visual because it exists only on paper. For example, a shareholder might find his overall investment shrinking if the shares in his portfolio drop in value because of lower share prices; these price differences can be counted as a “loss” on paper or for accounting or tax purposes. However, as long as the shareholder still holds the shares, the “loss” is not realised, and the book loss might later become a gain if the share price moves up again. To take another example, a buyer who purchases Brent crude oil in August 2005 in the spot market might find the price is much more expensive than 6 months earlier (if he could have bought them on February 2005). This is a loss in the sense that the buyer has made a bad decision as to the timing of his purchase, but it is not close to any legal meaning of “loss” as described above.

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*ANZ Banking Group Ltd* 2000 WL 1151384; Henderson, Henderson on Derivatives, at 6.15 (LexisNexis Butterworths, 2003). However, so far, this discussion has remained on issues of documentation. It has not been discussed whether a credit event that does not lead to credit deterioration would render a CDS unenforceable.

<sup>145</sup> A single-name CDS means that there is only one type of reference obligation (e.g. a specific type of bond issued by the General Motors). In contrast, there are multiple reference obligations in a basket (or portfolio) CDS. If one reference obligation is in default, it is enough to trigger the payment process of a basket CDS. Thus, it can help to hedge risks not only for one company but also for the risk exposure of an industry or the overall portfolio of an investor. See also explanation in *Deutsche Bank AG v Ambac Credit Products*, 2006 US Dist LEXIS 45322.



In sum, the insurable interest test in property has been developed in the special context of insurance, whereas a policy is described as a contract of indemnity and an established insurer acts as a risk-buyer. This context cannot be applied to other hedging contracts. The factual expectation test, though broader than the legal interest test, still refers to damage to property. Modern hedging practice is apparently wider than mere property damage and refers to broader economic losses. The simple purpose test should work better with more flexibility in the case of derivatives, if, as described above, notional hedging contracts and gambling differ mainly in the purpose of the transaction rather than in the structure of the contractual obligation.

### **4.4.3 An Analytical Structure**

As stated in Chapters 1 and 2, this thesis approaches derivative instruments as contracts to trade risks. Thus, we may place traditional gambling instruments and notional transactions on a continuum. At the one end, there are certain instruments whose payoff depends purely on luck (e.g. lottery) and form the core of what we generally call “gambling”. At the other end, there are certain instruments which may also involve a certain degree of speculation but which are largely seen as commercial instruments (e.g. investment in the stock market). In between, some transactions are generally labelled as “gambling” (e.g. bookmaking) and are usually controlled by gambling law, while others may have “betting” in name but are regulated as “investment” (e.g. financial spread betting in the UK—see 4.2.2.1 above).

If a transactional structure is an indication of whether a transaction may be seen as gambling, the purposes of contracting parties create another dimension. Some contracts may be used both for commercial and for speculative purposes; whether they should be seen as gambling or investment depends on the parties’ intention and interests. However, as we have argued above, a typical gambling contract may well be used as a hedge (see section 4.4.1 above). Therefore, it is not convincing to argue that traditional gambling instruments can only be used for pure speculation.

Instead, we explain Hobhouse J's observation that certain instruments (e.g. bookmaking) are by character betting (or wagering) transactions by arguing that the law assumes that bookmaking (and other typical gambling transactions, such as lottery or pool betting) is used for pure speculation.<sup>146</sup> Therefore, we do not need to challenge a punter's real purpose; nor do we need to consider whether a bookmaker is actually doing business by accepting bets (and is thus acting for commercial purposes).

We have argued that both notional transactions and traditional gambling instruments are aleatory in nature (see section 4.4.1 above), since they both hinge upon something that is in theory not within the control of either party.<sup>147</sup> The next issue, then, is how we should deal with these types of behaviour as a matter of public policy. Under the Gambling Act 2005, gambling for charitable purposes may be allowed.<sup>148</sup> Lottery schemes have been used for finance purposes in the past (see section 4.3 above). Being of speculative or aleatory nature does not necessarily make a transaction void or unenforceable. If we take into consideration the regulation of gambling (bookmaking, casinos, etc.), there is more to consider than mere civil unenforceability.

In addition, as at least two parties are needed to make a transaction, the identity of the parties in a transaction definitely influences how we approach a particular transaction and the public policy concerns behind the scene. For purposes of discussion, we may suppose that notional transactions can happen in the following four ways: 1) between two financial institutions; 2) between a financial institution and a customer (who is not a financial institution, but may be a company or a natural person); 3) between a non-financial institution (who carries on notional transactions as business) and a customer; and 4) between two private parties (who may be either company or natural persons but who do not carry on

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<sup>146</sup> For Hobhouse J's observation, see *Morgan Grenfell & Co Ltd v Welwyn Hatfield District Council* [1995] 1 All ER 1, at 11.

<sup>147</sup> This also means that problems may arise when the occurrence or non-occurrence of an event is within the control of (or, to a lesser extent, is known to) one party of a transaction. We will develop this point further in Chapter 5.

<sup>148</sup> Gambling Act 2005, sections 15, 33, 37 & Part 14. For Illinois, see, 720 ILCS 5/28-1(b); 230 ILCS 20/1 *et seq.* (Charitable Games Act). For New York, see NY CLS Const Art 1, section 9.

notional trading as business). Financial institutions, non-financial businesses and private persons can act as speculators or hedgers (or both) in transactions.

#### **4.4.3.1 Between Financial Institutions**

Financial institutions, which are supervised by national financial regulators, are probably the most vigorous players in the derivatives market. In principle, a financial institution is regulated in the first instance, being bound by certain prudential requirements such that any transaction carried out by that institution must be taken into account in determining the net risk exposure of its capital.<sup>149</sup> The purpose of prudential rules is to protect investors or customers of a financial institution in case of default or insolvency.

Under these circumstances, a different approach is required to the question whether a notional transaction between two financial institutions, either for speculation or for other commercial purposes, should be considered as “gambling”. Apparently less moral concern is involved in enforcing speculative transactions between two financial institutions; there is no additional need to protect minors, and there is less direct impact on natural persons or their families. Risk associated with these highly risky notional transactions should in theory be kept in check by prudential requirements or other kinds of financial regulation. This does not mean that financial regulation is perfect and can cope with any problem that may arise from risky notional transactions.<sup>150</sup> What we propose here is that it might be better to leave the evils caused by these speculative notional transactions to financial regulators rather than using anti-gambling laws to complicate the matter. In this regard, the statutory exemption provided by the FSMA 2000 in the UK<sup>151</sup> and by the Commodity Exchange Act in the US<sup>152</sup> is sensible.

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<sup>149</sup> See FSA Handbook, Prudential Standards. The FSA provides several sourcebooks for different types of financial institutions.

<sup>150</sup> For example, see Matthews, “Capital Adequacy, Netting, and Derivatives” (1995) 2 Stan JL Bus & Fin 167; Hall, “Basel II: Panacea or a Missed Opportunity?” (2006) 7(1/2) JBR 106.

<sup>151</sup> FSMA 2000, section 412 (repealed by Gambling Act 2005, section 334).

<sup>152</sup> 7 USCA 16(e)(2) & 15 USCA 78bb.

So far, we have assumed that the meaning of the term “financial institution” is clear. In fact, the kind of “institution” that is regulated by a broadly defined “financial regulation” is subject to national laws. The traditional three pillars of financial markets—banks, security houses and insurance companies—are still the major three types of players. Pension funds, or any kind of collective investment schemes, represent another group of financial institutions. We can safely assume that these institutions lie well within the ranks what we are usually referred to as “financial institutions”, and their regulations are therefore “financial regulations”. However, some new types of investment vehicles, such as hedge funds or financial betting companies, might create new taxonomical problems. The statement that a financial institution is governed by financial regulation, as we claimed above, is rather rough and ready. We still need to examine the content of legislation and the nature of an institution in order to determine whether we should use financial regulation as a proxy for addressing potential gambling/speculation problems.

#### **4.4.3.2 Between Two Private Persons**

If a notional transaction occurs without involving any financial institution, the question whether it constitutes gambling becomes more serious. We will start with the situation where a notional transaction is carried out between two unregulated private persons on an occasional basis. Then we will consider the situation where two business entities enter into a transaction purely for speculative purposes.

If we accept that the *raison d'être* of the purpose test is to distinguish gambling from other legitimate transactions, gambling laws should intervene only when both parties intend to speculate. In such cases, the question is on how far the policy of a specific jurisdiction controls gambling or speculation between private parties. If private gambling (or non-commercial gambling) is allowed,<sup>153</sup> discussing whether a notional transaction is gambling may be unnecessary. Thus, it would be lawful for two individuals in the UK to use movement of

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<sup>153</sup> E.g. see Gambling Act 2005, Part 14 and Schedule 15.

LIBOR<sup>154</sup> to make a series of bets, structured as an interest rate swap; in contrast, if gambling is itself unenforceable or even penalised (as in Illinois and New York), then a pure speculative transaction might be rendered unenforceable.

This problem extends to cases where we have two companies (not financial institutions) who enter into a speculative transaction. Then the questions becomes whether a company can gamble. Three points may be made. First, if a company specialises solely in making speculative transactions, it opens the door for financial regulation, since speculation frequently means earning price differences with notional transactions or with contradictory trades, such that it might be seen to be carrying on an investment business.

Secondly, a bet made by two companies might not be exempted from gambling regulation in the UK. There are two prongs. On the one hand, under the Gambling Act 2005 a bet made between two companies is classed neither as private gambling nor as non-commercial gambling except in cases where no party to the transaction has entered it in the course of business. In the latter case, it would open the door for the company to be regulated as a gambling business.<sup>155</sup> On the other hand, the Gambling Act 2005 does not apply if the betting-like transaction is within the ambit of the FSMA 2000.<sup>156</sup> However, the company also runs the risk of becoming an investment business.

Perhaps an easier way to get out of the trouble created by statutory interpretation is to employ the intention or purpose test developed by case law regarding wagering (albeit, technically speaking, the term wagering is no longer used in the 2005 Act—see 4.1.1 above). It is not entirely clear whether future UK courts will continue to use the same test for the construction of “betting” as under the Gambling Act 2005. However, it would be beneficial to exclude from the application of the Gambling Act 2005 notional transactions some part of which

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<sup>154</sup> The term “LIBOR” stands as “London Inter-bank Offered Rate”.

<sup>155</sup> Gambling Act 2005, section 302 & Schedule 15. We should be aware that in *Morgan Grenfell & Co Ltd v Welwyn Hatfield District Council* [1995] 1 All ER 1, Hobhouse J took a broad view of the meaning of “business” under the Financial Services Act 1986. *Id.*, at 12–13. So far, there is no particular reason to suggest that the “course of business” should be given a technical meaning. Thus, a company’s making a bet is probably enough to establish that the company is conducting commercial gambling.

<sup>156</sup> Gambling Act 2005, section 10.

has a more legitimate purpose (e.g. hedging financial risks) other than pure speculation. After all, the Gambling Act 2005 targets certain gambling activities rather than the full range of aleatory contracts.

Thirdly, further research into company law might help to explain how far a business entity should be allowed to pursue speculative goals. After all, business activities often involve a certain degree of speculation. As Bramwell LJ observed,

“[i]t may be a sad thing that there should be gambling upon the Stock Exchange, but that is not the point which we have to consider; and I am not sure that it is a disadvantage that there should be a market where speculation may go on, for it is owing to a market of that kind that we now have so many railways and other useful undertakings.”<sup>157</sup>

Surely a company (or a business entity) exists to make money. However, the means that the company may employ to make money is still at issue. A company’s investing in the stock market is probably universally acceptable. But whether it is permissible for companies to make money by laying bets with a bookmaker is less clear (even assuming that bookmaking is legal). Whether a company’s notional transactions, used purely for speculative purposes, should tilt toward investment or gambling remains to be seen. Thus, in the inter-relationship between investment, hedging, gambling and speculation there remains something to be thought through.

#### **4.4.3.3 Between A Specialist Firm and A Client**

Different problems would arise when a transaction takes place between a customer and a firm that specialises in dealing notional transactions. On the one hand, the ability to honour future obligations raises some concerns, especially when a firm deals with many different customers at the same time. On the other, if a firm makes certain types of transactions, this also raises more concerns about consumer and investor protection. (Insurance companies and insurance regulations provide a good comparison.) Some investor protection issues will

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<sup>157</sup> *Thacker v Hardy*, (1878) 4 QBD 685, at 692-693.

be discussed in the next chapter. Here, we will focus on the question of whether transactions between a business and a customer should be considered gambling.

The nature of the firm partly influences how we perceive a notional transaction. First, some banks (e.g. the Bankers Trust<sup>158</sup>) specialise in derivative transactions, and as banks are already subject to banking regulation, there seems no need to treat a notional transaction as gambling in order to protect the health of the bank and to protect customers. On the other hand, the prudential rules and conduct of business rules might have to be updated to reflect the development of markets and the increasing number of products. Arguably, however, banking regulation is sufficient to address potential speculative trading by regulated banks. Even if public policy dictates prohibiting a certain type of notional transaction to prevent excessive speculation, the question remains whether it is better to address these issues in banking regulation rather than general gambling laws.<sup>159</sup>

Secondly, some banks decide to establish subsidiary companies (often called “derivative product companies”, DPCs<sup>160</sup>) specialising in derivative transactions. A number of insurers or reinsurers also establish derivative products operations.<sup>161</sup> Whether these DPCs are legally “banks” (or insurance companies) is best left to the banking (or insurance) regulator to decide, although a DPC might also be regulated as a non-bank financial institution. In the UK, although the FSMA 2000 has a flexible concept of “contract for differences” which covers most of the notional contracts we mentioned above, it has not yet been fully tested in court. In the US, this matter depends on whether a contract falls within the scope of the Commodity Exchange Act (CEA) or the concept of “security”.<sup>162</sup> Many OTC derivatives are exempt from the application of the

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<sup>158</sup> The Bankers Trust has now been acquired by the Deutsche Bank.

<sup>159</sup> Some US commentators have noticed the similarity between investments, insurance, gambling and derivative instruments and propose a more harmonised approach to revise current regulatory programmes. See Hurt, *supra* note 67; Hazen, *supra* note 104.

<sup>160</sup> One of the main purposes of establishing a DPC is to control a bank’s exposure to credit risk from derivatives trading. Das, *Risk Management*, at 339 *et seq.* (3rd ed. rev edn, John Wiley & Sons, 2006).

<sup>161</sup> For example, AIG has set up AIG Financial Products Corp to specialise in derivative business. See Das, *Structured Products Volume 2: Equity; Commodity; Credit & New Markets*, at 1183 (3rd ed. rev edn, John Wiley & Sons, 2006).

<sup>162</sup> 7 USCA 1a & 6 (Commodity Exchange Act); 15 USCA 77b(a)(1) (security).

CEA and/or securities laws if they take place between two financial institutions or between business entities.<sup>163</sup> However, a contract might not escape federal regulation if it is between a business and a client. Bank regulators have a clear interest in controlling a bank's use of DPCs to conduct derivatives trading.<sup>164</sup> Whether it is better to create a new regulatory regime for DPCs under current financial regulation, or even to regulate them under gambling regulations, is another issue that is open for further discussion.

Thirdly, it is certainly possible for non-financial firms to specialise in notional transactions. How the public perceives this kind of firm may partly depend on how it promotes its business. If a firm promotes its business as "hedging" or emphasises its financial nature, people may be more inclined to look for financial regulations. If, on the other hand, a transaction is promoted as betting, it looks more like a professional betting company (as in *City Index Ltd v Leslie*<sup>165</sup>). In the UK, a spread betting firm is currently being regulated under the FSMA 2000 rather than the Gambling Act 2005.<sup>166</sup> This is an indication that UK law prefers to regulate financial betting companies under the umbrella of financial regulation. However, in other jurisdictions lacking a comprehensive regulatory scheme like the FSMA 2000, there is the possibility that a spread betting company might be regulated like a bookmaker (or directly prohibited). This is a policy decision that requires an overview of the whole regulatory structure of the financial and gambling market.

Fourthly, we also have to consider the situation where a client intends to speculate rather than to hedge. We cannot rule out the possibility that both the client and the business intend the transaction to be speculative (or, in other words, gambling in nature). If the intention or purpose test should be adopted as argued

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<sup>163</sup> See sections 403–405 of the Commodity Futures Modernization Act of 2000, Public Law 106-554 (2000), and section 206 of the Gramm-Leach-Bliley Act (1999) (identified banking product).

<sup>164</sup> For example, the FSA Handbook provides rules regarding how to calculate capital and risk exposure for prudential purposes when a bank trades derivative instruments or uses special purposes vehicles to attract capital. See FSA Handbook, BIPRU 7. A bank also has to calculate its capital adequacy on a consolidated group basis. See FSA Handbook, BIPRU 8. See also FSA Handbook, INSPRU 3.2 for uses of derivatives by insurance companies.

<sup>165</sup> [1992] QB 98.

<sup>166</sup> *Supra* 4.2.2.1.



above, and if a client is intent upon gambling rather than hedging, we have to turn to the business's side to determine the enforceability of a notional contract. The common law solution is based on the purpose of a transaction and can only be determined on a case-by-case basis. Again, whether it is better to rely on common law to disrupt pure speculative transactions or whether we need to upgrade to a regulatory and licensing scheme to address the issue might be a direction for future research.

In the above discussion, we categorically distinguish transactions between two financial institutions, between two private parties, and between a specialised firm and a client. In fact, it is not always easy to label market participants in such a way. A financial institution may lack expertise in some aspects of hedging and thus may look like a client to the other specialist financial institutions. A transaction may also be carried out between two private parties but arranged by a bank.<sup>167</sup> We have to consider the structure of the risk trading market in order to designate a proper legal regime to curb speculation, either by way of civil enforceability/illegality or through a licensing scheme. Using common law or regulation to impose a duty on special firms might be another option. We will develop some of these issues in the next chapter.

In short, traditionally we have seen wagering, gaming, fixed-odds betting, pool betting etc. as falling within the ambit of gambling laws. It is now the turn of some more modern transactions to face the challenge. The whole regulatory structure has to be examined to determine whether it is better to leave regulated financial institutions to deal with notional transactions; whether it is better to identify specialist firms for gambling licences independent of financial regulation; and whether it is proper to disrupt all notional transactions falling outside the financial services industry.

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<sup>167</sup> As in *Morgan Grenfell & Co Ltd v Welwyn Hatfield District Council* [1995] 1 All ER 1. See *supra* 4.1.1.

## 4.5 Conclusion

In this chapter, we focus on whether notional transactions are any different from gambling. Following the *Morgan Grenfell* judgment, we identify several instruments that we generally call “gambling” and which raise certain problems that invite the intervention of gambling laws. We recognise that notional transactions could be used for pure speculation, and speculation might raise similar problems to gambling.

It has been argued that traditional gambling instruments and notional derivative transactions are all aleatory in nature; in a way, they are all contracts to trade future uncertainties. Traditional gambling instruments and derivative transactions refer to certain types of transactional structure. However, whether a specific type of transactional structure is used for pure speculation or for other, more legitimate purposes depends on the intention of one or both parties. As a matter of law, we might assume that traditional gambling instruments are used purely for speculation. However, the law is less clear about newly developed speculative instruments in the world of derivatives.

The next question is how we should consider gambling and speculation. As there might be a variety of policy concerns in different jurisdictions, we have designed an analytical structure capable of hosting different types of speculators and market participants. In light of the modern development of financial and gambling regulation, the whole regulatory structure relating to gambling and market speculation should be considered as a whole. We argue that if speculation by notional transactions occurs only between two financial institutions, it might be better to leave financial regulators to worry about speculation. In contrast, when speculation occurs between two private persons, what is important is whether the gambling laws of the relevant country allow private gambling.

A more intriguing issue is where two business entities enter into notional transactions purely for speculation. Further arguments might be developed in company law to sort out the use or misuse of speculative instruments in pursuit of

certain goals. In the end, if a notional transaction occurs between a specialist firm and a client, this raises more regulatory concerns over customer protection. This thesis takes the position that financial regulation is not the only source of reference; as a matter of public policy, we should also take gambling regulation into account. This requires further regulatory assessment on the overall costs and benefits of regulating a certain type of business, on the basis of different regulatory schemes.

## Chapter 5 Information and Risk Trading

In the previous two chapters, we illustrated how risks can be traded via standardised trading and how hedging can be conducted through physically deliverable contracts and cash-settled notional transactions. In this chapter, we will turn to another fundamental problem of risk trading—information and uncertainty.

Risk trading relies heavily on information and there is a range of disclosure and non-disclosure rules in different legal fields. The insider dealing rule also provides another angle from which to approach potential information problems in risk trading. In light of certain disclosure rules in laws relating to securities and insurance, we might further inquire whether derivative instruments are another type of contract *uberrimae fidei* or whether the disclosure rule attaching to securities could be extended to apply to derivative transactions. From this perspective, the information problem might influence the nature of derivative instruments and might raise further regulatory issues.

In this chapter, we will examine whether disclosure rules in securities regulation and insurance law are applicable to derivative instruments on the basis of the general non-disclosure rule in common law. We will argue that neither the securities nor insurance disclosure rules are completely suitable for the derivatives market. It is arguable whether we need to create a special rule for risk trading contracts and an analysis of market manipulation might provide a better basis for accessing potential information problems in the risk trading market.

## 5.1 Information Problems in Risk Trading

### 5.1.1 Information and Trading

Information problems can best be illustrated by an old American case, *Laidlaw v Organ*,<sup>1</sup> a case about a tobacco sale in New Orleans in the early 19th century. During that time, New Orleans was under blockade by the British Navy during the war of 1812 and the price of tobacco would have been higher had the blockade been lifted. When the Treaty of Ghent was signed and the news spread through Britain and Washington, people in New Orleans were still ignorant of this fact. Before the news reached other traders in New Orleans, the defendant-buyer somehow learnt the news from another person who was with the British fleet at the time. The buyer then entered into a sale agreement with the claimant and some tobacco was delivered. Soon after, news of the peace treaty was circulated and the claimant-seller felt he had been cheated, so he brought a lawsuit to stop the buyer from disposing of the tobacco that had been delivered and refused to make delivery of the rest. The issue was whether the buyer should have disclosed this important information to the seller and whether, upon inquiry by the seller, the buyer could keep silent on the issue. Unfortunately for Laidlaw, the US Supreme Court refused to impose a duty of disclosure on Organ.

Although *Laidlaw* was in the context of a physical sale, the same scenario could appear in the hedging or speculative contracts that we discussed in previous chapters. Had the contract between Laidlaw and Organ required delivery of tobacco three months after the conclusion of the contract, it would have become an information problem for a forward contract. On the other hand, gambling could shed some light on the speculative aspect of risk trading contracts, for if both parties in *Laidlaw* had wagered on the level of tobacco prices in the following month instead of concluding an immediate physical sale, the withholding of information by Mr. Organ might have constituted fraud or cheating.

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<sup>1</sup> 15 US 178 (1817).

Since trading risk deals with future uncertainties, proper evaluation of the risk exposure relies heavily on all sorts of information. An uncertainty is uncertain because one does not really know when and how it might strike. Possible impact from future risk can be better accessed if one has better knowledge and information. One source of information is past events or the past performance of a market (e.g. the past price cycle for new crops). Another is traders' knowledge (e.g. the prospects of the oil market based on current information) or advice given by another person, the reliability of whose advice would be determined by his expertise. A more interesting source of information is the occurrence of a current or future event that might have an impact on the market. Indeed, any political or corporate event might have some impact on the market; tobacco prices in *Laidlaw* are a good illustration of this.

However, since acquiring and distributing information incurs costs and since the information itself might be valuable enough to prohibit it from being free flowing, there could be an information gap between someone who holds the information and someone else who has not been informed. In *Laidlaw*, Laidlaw did not learn the news of the Ghent Treaty because it took time for this information to arrive in New Orleans.<sup>2</sup> A lack of information of this kind could create problems before or after a contract is made. With the help of modern telecommunication, the Internet, and the multi-media, situations similar to *Laidlaw* are less likely to occur again because information can be transmitted around the world much more quickly and at a lower cost than in 1812. However, even a few minutes difference might be enough to earn a fortune for a trader.<sup>3</sup> Information dissemination is still an issue that has to be considered, especially

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<sup>2</sup> Another interesting story is how a banker called Nathan Rothschild earned huge profits by having advance information about the outcome of the Battle of Waterloo before other traders learnt the news. See Karlgaard, "Winning – It's All About Information" *Forbes* (24 October 2005) <[http://www.forbes.com/2005/10/20/karlgaard-rich-information\\_comm05\\_cz\\_rk\\_1024karlgaard.html](http://www.forbes.com/2005/10/20/karlgaard-rich-information_comm05_cz_rk_1024karlgaard.html)> (visited on 23 October 2006). See also Avgouleas, *The Mechanics and Regulation of Market Abuse*, at 122 (OUP, 2005).

<sup>3</sup> Dan Morgan has depicted how a trader picked up the most up-to-date news from all around the world, including listening to the English version of Radio Moscow in the hope of getting a tip about Russian grain, and how a trader recovered a loss by delaying publishing news regarding a new big transaction. See Morgan, *Merchants of Grain*, at 282-286 (Penguin, 1980).

when we consider the fact that not every trader possesses equal tools and expertise in the risk trading market.

*Laidlaw* is a typical example of a pre-contractual disclosure issue. If non-disclosure pertains after the conclusion of a contract, it might become a so-called “moral hazard” problem. In this chapter, we will focus on information issues in a pre-contractual context. Against this backdrop, we might find that information creates problems in various ways. For example, the following situations might happen:

- (1) One party provides false information to the other party with regard to a fact;
- (2) One party makes his prediction and this prediction turns out to be inaccurate;
- (3) One party conceals some information from the other party when the other makes an inquiry;
- (4) A person is not asked for key information by the other party, and chooses not to disclose (or hides) it;
- (5) One party is either the generator of a price-influencing event or a close insider to that event.

In this chapter, we will focus on what Professor Treitel has called “‘pure’ non-disclosure”.<sup>4</sup> In principle, then, we will deal with issues (3) to (5) rather than going into detail over cases of deceit or misrepresentation except where relevant.

It should be noted that the importance of information is not exclusive to risk trading contracts but is relevant to all kinds of transactions. Information is crucial in ascertaining the real value of a property (e.g. the health of pigs on sale<sup>5</sup> or the unknown quality of a stone<sup>6</sup>). Information is also important for service or employment contracts (e.g. a criminal record in the case of a security guard). There is no doubt that the law regarding fraud, misrepresentation and mistake plays a role in shaping the relationship between parties. We recognise that

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<sup>4</sup> Professor Treitel uses the term “pure non-disclosure” to describe the situation where non-disclosure does not give rise to misrepresentation, negligence, or deceit. See Treitel, *The Law of Contract*, at 436 (12th ed. by Peel, Sweet & Maxwell, 2007).

<sup>5</sup> *Ward v Hobbs* (1877) 3 QBD 150.

<sup>6</sup> *Wood v Boynton*, 25 NW 42 (1885).

information is essential for risk trading, but this does not necessarily mean that risk trading requires a different disclosure rule from other commercial contracts. Thus, in the present chapter, we will first discuss the current common law rules with regard to pre-contractual information disclosure and the limits of the laws regarding deceit and misrepresentation, and we will further examine some special categories where there is a duty of disclosure that may be applied to risk trading contracts.

### 5.1.2 Current Laws on Pre-contractual Disclosure

If one party's lack of information causes some problems, forcing the other party to disclose the information (by avoiding the contract, providing compensation or using other remedies) seems to be the most direct way to address the issue. However, in general, there is no pre-contractual duty of disclosure in common law.<sup>7</sup> "Let the buyer beware" (*caveat emptor*) is thus the general principle.

On the other hand, there also exist several exceptions to the general non-disclosure rule. The first exception is the so-called contract of utmost good faith (contract *uberrimae fidei*), of which insurance is the most typical example.<sup>8</sup> To observe the utmost good faith "the assured must disclose to the insurer, before the contract is concluded, every material circumstance which is known to the assured".<sup>9</sup> If the assured fails to disclose, the insurer could avoid the contract.<sup>10</sup>

Secondly, a person might have to disclose information if he has a special relationship with the counterparty. Where there is a relationship of trust between parties, there may be a duty of disclosure; for example, pre-contractual disclosure might be required to a certain degree for a partnership agreement<sup>11</sup> or a contract to marry or separate.<sup>12</sup> A stronger form of trust and confidence would

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<sup>7</sup> In *Keates v Cadogan*, it was held that the landlord did not have to disclose the condition of the flat to potential tenants. (1851) 10 CB 591. See also *Bell v Lever Brother, Ltd* [1932] AC 161 (per Lord Atkin); *Laidlaw v Organ*, 15 US 178 (1817).

<sup>8</sup> Marine Insurance Act 1906, section 17.

<sup>9</sup> Marine Insurance Act 1906, section 18.

<sup>10</sup> *Id.*

<sup>11</sup> See *Conlon v Simms* [2006] 2 All ER 1024.

<sup>12</sup> Bower et al., *Law Relating to Actionable Non-disclosure*, at sections 1.05, 10.01 *et seq.* & 11.01 *et seq.* (Butterworths, 1990).



create what we call a fiduciary relationship. However, we should be aware that a fiduciary duty does not automatically imply a duty of disclosure. We have to carefully analyse the extent of fiduciary duty in different contexts before concluding whether a party has to disclose certain information before a contract is made (see section 5.4.2 below).

Thirdly, disclosure is frequently required by statute. For example, a company wishing to list its shares on a stock exchange has to disclose certain information to investors in the listing particulars or prospectus (see also 5.2 below).<sup>13</sup> We should be aware that while the Financial Services Authority (FSA) imposes a duty on issuers of financial instruments traded on regulated markets (i.e. exchanges) to disclose inside information<sup>14</sup>, this duty of disclosure is not extended to all traders on the financial market (notably OTC derivative traders). We will have further discussion of insider dealing in section 5.5.

Fourthly, the need to disclose information may derive from tort law. A person might have to disclose to avoid fraud or misrepresentation, particularly when there is a continuous representation.<sup>15</sup> It is not surprising that several non-disclosure cases refer to “fraud”.<sup>16</sup> Arguably, a person might have to disclose certain information to avoid liability under the tort of negligence if a duty of care is established. However, we should note that liability in tort law does not necessarily mean a duty to disclose to the counterparty. In addition, a person must avoid misrepresentation, but this would not be translated into a duty to disclose unless the non-disclosure itself is deemed a misrepresentation.

In principle, one is not liable for one’s silence unless such silence might establish fraud or misrepresentation.<sup>17</sup> Thus, one might escape liability if one merely

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<sup>13</sup> See Financial Services and Markets Act 2000, section 80.

<sup>14</sup> See FSA Handbook, DTR 2.

<sup>15</sup> The definition of “fraud” or deceit could be found in *Derry v Peek* (1889) 14 App Cas 337, at 374 (per Lord Herschell). For continuous misrepresentation, see *With v O’Flanagan* [1936] Ch 575; *Spice Girls Ltd v Aprilia World Services BV* [2002] EWCA Civ 15. See also Restatement of Contracts 2d, section 161. Cf. Unfair Commercial Practices Directive (2005/29/EC), Articles 6 & 7.

<sup>16</sup> For example, Lord Mansfield’s remarks on insurance disclosure, see *infra* note 59 & 60; and Mr. Justice Blackburn’s analysis on insider dealing, see *infra* 5.5.1 and note 122.

<sup>17</sup> Blackburn J states that “a mere abstinence from disabusing the purchaser of that [mistaken] impression is not fraud or deceit”. *Smith v Hughes* (1871) 6 QB 597, at 607. See also *Ward v*

chooses not to disclose information to the other party rather than disclosing wrong information, which increases the difficulty of using the concepts of deceit or misrepresentation to deal with the situation in *Laidlaw*. Things could become more complicated if the other party inquires about knowledge on a certain matter and the first party does not answer properly. We should note that other aspects of private law have evolved to address some of the issues regarding silence. For example, product liability and product safety regulations also force a manufacturer to disclose certain information to consumers.<sup>18</sup>

It is important to note that there is a limited class of duty of disclosure in New York. Under New York law,

“[i]n business negotiations, an affirmative duty to disclose material information may arise from the need to complete or clarify one party's partial or ambiguous statement ... or from a fiduciary or confidential relationship between the parties... Such a duty may also arise ... where: (1) one party has superior knowledge of certain information; (2) that information is not readily available to the other party; and (3) the first party knows that the second party is acting on the basis of mistaken knowledge.”<sup>19</sup>

This duty of disclosure has often arisen in the context of fraud and misrepresentation.<sup>20</sup>

In short, what could be perceived as “fraud” by the general public might not translate directly into the tort of deceit or misrepresentation. The tort of deceit and the law of misrepresentation could well apply where one makes a wrong statement with regard to a fact; likewise, spreading false information in the financial market is usually prohibited.<sup>21</sup> However, their application is limited

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*Hobbs* (1877) 3 QBD 150; *With v O’Flanagan* [1936] Ch 575; *HIH Casualty and General Insurance Ltd v Chase Manhattan Bank* [2001] 2 Lloyd’s Rep 483, at 494 (*per Rix LJ*).

<sup>18</sup> Consumer Protection Act 1987, sections 2 & 11.

<sup>19</sup> *Banque Arabe et Internationale d’Investissement v Maryland National Bank*, 57 F 3d 146, at 155 (1995). See also *Young v Keith*, 492 NYS 2d 489 (1985). We should also notice that some American courts did impose a duty to disclose defects of a house if the seller knows of a defect that would materially affect the value of the house. See *Johnson v Davis*, 449 So 2d 344 (1985); *Soloman v Birger*, 477 NE 2d 137 (1985).

<sup>20</sup> In both *Banque Arabe*, *id.*, and *Young*, *id.*, this duty was discussed in the context of fraud.

<sup>21</sup> For example, see *CFTC v Atha*, 420 F Supp 2d 1373 (2006); *CFTC v Erskine*, 2006 US Dist LEXIS 26319; *CFTC v Foley*, 2006 US Dist LEXIS 70437.

where a statement is merely an opinion and might not be “false” in the strict sense. The broader meaning of “fraud” might be more of rhetorical than of any real use. We have to recognise the limited scope of the common law remedies for deceit and misrepresentation with respect to information problems, particularly when they involve pure non-disclosure of certain information.

### **5.1.3 Theories of Disclosure or Non-Disclosure**

It is difficult to provide a comprehensive theory that incorporates all the disclosure and non-disclosure positions in law. Where there is no previous contractual relationship between the same two parties, a duty of disclosure cannot be based on the contract itself. As Judge Posner observed, “[a] general duty of disclosure would turn every bargaining relationship into a fiduciary one”,<sup>22</sup> which is not desirable as a matter of law. On the other hand, the laws of tort, deceit, and misrepresentation operate as a restraint on the common law non-disclosure rule. When a non-disclosure is seen as a wrong in the eyes of law, it has to be corrected. But it is the area between fraud/misrepresentation and the common law non-disclosure rule that invites problems.

We have noted at least two levels of discussion regarding disclosure of information. On the one hand, there are debates on pre-contractual disclosure issues for each individual contract, particularly in the context of sales and insurance, where the discussion focuses on the private law impact of non-disclosure. On the other, there are many arguments on the rights and wrongs of mandatory disclosure rules in the securities market (see section 5.2 below). Interestingly, these discussions show some similarities. Using a kind of shorthand, we might call concerns about a single transaction the “micro level” and those about the market the “macro level”.

First, fairness is a key concern at both micro and macro levels. To some eyes non-disclosure is simply not “fair”, though why it is not fair might require further explanation. For example, if a private seller knows very well that his house is infested with termites but chooses not to say so clearly, it is fair to say that most

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<sup>22</sup> *Federal Deposit Insurance Corp v WR Grace & Co*, 877 F 2d 614, at 619 (1989).

buyers would feel they have been treated unfairly, if not fraudulently, by the seller's concealment in this circumstance.<sup>23</sup> The duty of utmost good faith in insurance law might also embrace the idea of unfairness (see section 5.3.2 below) and similar lines of thinking could also be found in the context of insider dealing (see 5.5.1 below).

However, whether a conduct should be considered "unfair" to the point of affecting a concluded transaction is certainly subject to disagreement, so this is where we should be cautious about making a fairness argument, as the standard for unfairness is open to challenge.<sup>24</sup> Inequality of bargaining power might also influence how we perceive "fairness" in a certain case; the same act (of non-disclosure) might be deemed acceptable practice between two business entities, but our conclusion might be different if it concerns a transaction between a business and a customer. In short, we do recognise that some disclosure rules might have moral underpinnings, but it is not easy to form a complete ethical theory as guidance for each issue of disclosure.

Secondly, economists provide certain arguments for the view that a person should not be forced to disclose information which has higher productive value, so as to encourage people to invest in discovering this information. In contrast, withholding information that would produce no further social value (e.g. a person withholding information acquired by eavesdropping on other people's conversations) may only induce more opportunistic behaviour.<sup>25</sup> A few academic debates use similar but subtly different language on this issue.<sup>26</sup> In a recent article, Eisenberg argued that a seller should disclose in any event but a buyer may be free from this duty if the information is more than

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<sup>23</sup> See for example, *Hill v Jones*, 725 P 2d 1115 (1986); *Obde v Schlemeyer*, 353 P 2d 672 (1960).

<sup>24</sup> See generally, Strudler, "Moral Complexity in the Law of Nondisclosure" (1997) 45 UCLA L Rev 337.

<sup>25</sup> See generally, Eisenberg, "Disclosure in Contract Law" (2003) 91 Calif L Rev 1645.

<sup>26</sup> For example, Kronman distinguishes information acquired casually and information obtained intentionally and requires the former to be disclosed but not the latter. See Kronman, "Mistake, Disclosure, Information, and the Law of Contracts" (1978) 7 J Legal Stud 1, at 13. Cooter & Ulen distinguish productive information (that could be used to produce wealth) and redistributive information (which only redistributes wealth) and requires the holder of the latter type to disclose. Cooter & Ulen, *Law and Economics*, at 273 (3rd ed., Addison-Wesley, 2000). See also Hirshleifer, "The Private and Social Value of Information and the Reward to Inventive Activity" (1971) 61 Am Econ Rev 561.

foreknowledge,<sup>27</sup> if it is not acquired through improper means, or if there is a relationship of trust and confidence between parties.<sup>28</sup> We do not intend to enter into these debates in the present thesis. Nevertheless, we should be aware that holding material information in the pre-contractual stage would have certain economic effect on contractual parties and society.<sup>29</sup>

Thirdly, as there are some concerns with the integrity of “prices” or the market, economic analysis has a stronger appeal at the macro level, particularly in the securities market.<sup>30</sup> Presumably, in an efficient market, the current market price should reflect all the information available in the market. Several finance theories explore the relationship between market information and the market prices of securities (so-called “market efficiency”).<sup>31</sup> No matter how quickly information percolates into the market, it is beyond doubt that information does in fact influence the market and in turn investors. Thus, if a piece of material information is not disclosed to the market in time, this might mean traders buy or sell at the “wrong” price, in the sense that the price does not reflect the true market value. Thus, economic theories lay the foundation for the modern securities mandatory disclosure rule. However, we should be aware that there are other theories arguing against the mandatory disclosure regime in securities law.<sup>32</sup>

Economic and moral arguments may not be mutually exclusive. While it seems natural to focus on the price issues on the securities market, we should also note that information might also influence market prices outside organised securities

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<sup>27</sup> The concept of “foreknowledge” was first introduced by Hirshleifer in 1971 in contrast to the concept of “discovery”. Foreknowledge means knowledge that will be evident to all in due time, which means something that will be autonomously revealed. In contrast, discovery is to recognise something that possibly already exists, though it is hidden from view. *See* Hirshleifer, *id.*

<sup>28</sup> *See generally* Eisenberg, *supra* note 25, at 1687.

<sup>29</sup> *See also* Fried, *Contract as Promise*, at 77–85 (Harvard University Press, 1981); DeMott, “Do You Have the Right to Remain Silent?: Duties of Disclosure in Business Transactions” (1994) 19 *Del J Corp L* 65.

<sup>30</sup> The wrongful price theory might concur with “artificial price” arguments in defining market manipulation. Theories relating to non-disclosure and market manipulation might be connected in cases regarding insider dealing, which we will discuss in *infra* section 5.5.

<sup>31</sup> For discussion on the so-called efficient capital market hypothesis, *see generally*, Avgouleas, *supra* note 2, at 44 *et seq.*

<sup>32</sup> *Id.*, at 179–183.

exchanges (e.g. in *Laidlaw*). It is not clear how far the wrongful price theory can be applied to non-securities markets or non-standardised markets. To some extent, it requires further empirical research to justify market efficiency and to build a link between a piece of information and prices in specific spot or futures markets. In contrast, where economic arguments seem to be dominant in the securities market, there is still a certain line of moral arguments that attempt to justify the use of some mandatory disclosure rules in the securities market, particularly regarding insider dealing (see section 5.5.1 below). With regard to risk trading contracts, it is important to be aware of different concerns rather than relying on a single school of thought.

### 5.1.4 Summary

In this part, we determined that information is important to hedging and speculation as the evaluation of future risks depends heavily on information and expertise; thus, this opens the door for people to gain profit from their information advantage. The general rule in common law is that one does not have to disclose information before a contract is made, except in certain exceptional situations. In addition, we also find that the laws of deceit and misrepresentation have a limited application to the silence of a trader in a pre-contractual context. Since information problems appear in every kind of contract, there is no reason to create a different rule in the legal structure merely because evaluation of risks requires a lot of information. The approach taken in this chapter is to fit risk trading contracts into the general common law structure. The laws of deceit and misrepresentation could apply if all elements are satisfied. What we are concerned with is whether one party has to disclose information to another party before concluding a contract in the context of risk trading. In the following sections, we will try to fit risk trading contracts into certain exceptions to the general non-disclosure rule and decide whether derivative instruments naturally come under these exceptions.

## 5.2 Mandatory Disclosure in the Securities Market: Comparison with Futures Exchange and Securitised Products

Before turning to the private law side of disclosure discussion, it would benefit this discussion first to look at the mandatory disclosure rules in the securities market. It is natural to draw a comparison between the futures market and the securities market, since futures contracts are also traded in organised exchanges, like many listed securities. While it is instructive to note the role of the securities disclosure rule and the insider dealing rule in maintaining the market, we should not ignore the differences between securities and futures contracts that might lead to various legal implications.

Two aspects of securities disclosure impinge upon the issuer of a stock or a bond. On the one hand, the issuer of a security must provide some information in the prospectus when first issuing or listing the securities in the market for investors to subscribe.<sup>33</sup> This is disclosure in the so-called “primary market”. On the other hand, the issuer is subject to a continuous duty of disclosure after the initial public offering, periodically having to disclose the operation of business and relevant accounting documents. Depending on statutory wording, key information that may have an impact on the market prices of the securities should also be disclosed promptly to the public.<sup>34</sup> This is disclosure in the “secondary market”. In addition, the insider dealing rule also supplements the general securities disclosure rule such that an “insider” may not exploit information for his own benefit before the information is published through the proper channels. The exact scope of securities disclosure rules depends on statutory wording and thus varies from jurisdiction to jurisdiction. The same may also be said for the insider dealing rule.

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<sup>33</sup> For UK law, see FSMA 2000, sections 80–82; for US law, see 15 USCA 77j.

<sup>34</sup> See generally FSA Handbook, Disclosure Rules and Transparency Rules (DTR); for US law, see SEC Regulation S-B, S-K and S-X, 17 CFR parts 228, 229 and 210.

Different legal consequences ensue from non-disclosure under securities laws, where non-disclosure does not render a contract void (as in insurance), but regulators may impose penalties for failure to disclose properly.<sup>35</sup> The issuer or directors of the issuing company might also be liable for damage suffered by subscribers.<sup>36</sup> Where the disclosed information is false or misleading, there might be an overlap with the laws of deceit and misrepresentation.

In addition, what is special in the securities disclosure rule is that it refers to general “issuance”. In the primary market, disclosure in the prospectus or listing particulars is prior to each individual subscription, but non-disclosure does not necessarily give the subscriber the right to set aside his subscription. In the secondary market, the issuer should disclose information to the market regularly or when necessary. Unlike in insurance, the securities disclosure rule does not refer to any specific transaction in the secondary market. A stockholder might sell his shares to another buyer without disclosing anything, unless he is under a duty to disclose or if he is prohibited from using his informational advantage. The insider dealing rule refers to individual transactions in the market made by “insiders” (see section 5.5.1 below). As with securities mandatory disclosure, the insider dealing rule does not avoid a contract, but imposes penalties or orders disgorgement of profits as remedies.<sup>37</sup>

The mandatory securities disclosure rule exists partly because of the nature of securities (a stock, a bond or other investment contracts as defined by statutes), whose price depends on the value and performance of the issuing company. The value of a share in a company is determined by many factors, including the operation of the company, its sales figures, the financial management of its account, and the prospects of the issuing company. The price of a corporate bond is influenced by the creditworthiness of the issuing company which is also affected by the issuer’s performance in its own business. The value of a unit

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<sup>35</sup> FSMA 2000, section 91.

<sup>36</sup> FSMA 2000, section 90. See also *Re South of England Natural Gas and Petroleum Co, Ltd* [1911] 1 Ch 573. *Per* Swinfen Eady J, “[i]n my opinion the allottee is not entitled to rescind his contract because of any breach of the statutory requirements, which extend to such comparatively unimportant matters as the names and addresses of the company’s auditors. His remedy is against the directors and other persons responsible for the prospectus.” At 577.

<sup>37</sup> See FSMA 2000, section 382 *et seq.* (restitution orders).



trust is basically decided by the portfolio value of the investment instruments held by the trust. Given that any positive or negative information could influence the market price—the value for holders of the securities—it is argued that the issuer should promptly provide correct information to the market.<sup>38</sup> Thus, requiring the issuer to disclose information to the market is a way both to maintain the market and to ensure the efficiency of the market price.

In contrast, this concern is less important in a futures exchange. On the one hand, a futures price represents the market's expectation of the future (or, to some extent, traders' expectations). A futures market is not, like the securities market, a spot market, so it is relevant to ask how far a futures price might be comparable to its corresponding spot price. The gold price for a December 2006 delivery contract in April 2006 is the market's expectation of the value of gold in December 2006 at the time of April 2006 and of course this is different from spot market gold sales prices in April 2006, which represent the current market value of the same amount of gold if one wants to take immediate delivery.<sup>39</sup> Moreover, a "true" futures price might not be easy to establish in any event.<sup>40</sup> Why would we need the futures market if we could already establish future price with a good degree of accuracy? So we can only wait for the future to prove whether or not the futures price at a certain point of time in the past was correct. Thus, we have to be careful when applying the analysis developed in the spot securities market to the futures market.

On the other hand, it is also probably not practical to impose a general duty of disclosure on every futures trader. A general mandatory disclosure system in the commodities market would mean that, if a farmer traded in the futures market, he would have to disclose information whenever he produced the crops for sale (*cf.* the primary securities market) or make periodical statements about

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<sup>38</sup> See generally, Avgouleas, *supra* note 2.

<sup>39</sup> For the relationship between spot prices and corresponding futures prices, see Chapter 3, section 3.3.2.3, particularly Mustill J's remark in *Gebrüder Metelmann GmbH & Co KG v NBR (London) Ltd* [1984] 1 Lloyd's Rep 614, at 623-624.

<sup>40</sup> The "artificial price" argument might have important implication in establishing market manipulation. However, this "artificial price" approach has also been heavily criticised as it is difficult to prove an "artificial" price. See Fishel & Ross, "Should the Law Prohibit 'Manipulation' in Financial Markets?" (1991) Harv L Rev 503; Perdue, "Manipulation of Futures Markets: Redefining the Offense" (1987) 56 Fordham L Rev 345.

the conditions of his crops whenever a specific futures contract remained open for trading (*cf.* secondary securities market). It is not impossible to establish this kind of regime, but it would be costly to maintain such a system. We should be aware that the basis of the securities disclosure rule is built on the basis that an issuer has to apply for authorisation from, or register with, the financial regulator before issuing or listing securities. The same does not usually apply in the commodity futures market.

We could also examine the issue from another angle. As a US judge has argued, the securities market was established for the formation of capital and the futures market for hedging.<sup>41</sup> It is normal that a lender attempts to acquire certain information about the borrower in order to ensure the return on his investment or to secure future repayment and yet no duty of disclosure is imposed in the case of loan agreements. Raising funds by way of issuing securities to the general public raises further concerns about investor protection because the general public might not be able to obtain useful information when making investments (compared with specialised lending banks giving loans or mortgages).<sup>42</sup> In contrast, futures contracts have no such pedigree to justify a pre-issuance and continuous disclosure rule.

If we follow this line of analysis, there might be good reason to apply the securities disclosure rule to those securitised hedging instruments as they may be seen as “securities”. A catastrophe bond (see section 2.2.2.4 above) is still a bond, although the repayment of the bond is conditional upon the non-occurrence of the catastrophic events defined in the indenture. Securitised instruments are not issued like a straight corporate bond as they are usually structured through a special purpose vehicle (SPV).<sup>43</sup> Nevertheless, similar concerns might arise with respect to these hybrid instruments and, thus, one might argue that hybrid

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<sup>41</sup> *Chicago Mercantile Exchange v SEC*, 883 F 2d 537, at 543 (1989)(*per* Judge Easterbrook).

<sup>42</sup> In contrast, the US securities law exempts an issuer from the obligation to register his transaction if it does not involve any public offering. 15 USCA 77d.

<sup>43</sup> See Henderson, Henderson on Derivatives, Chapter 8 (LexisNexis Butterworths, 2003); Das, Structured Products Volume 2: Equity; Commodity; Credit & New Markets, chapter 12 (3rd ed., rev edn, John Wiley & Sons, 2006); Benjamin, “Synthetic, Insurance and Hedge Fund Securitisations” (2005) 20(7) JIBLR 354; Zhang, “Trends and Developments in Cross-Border Securitisation, Part 1: Legal Structures and Analysis” (2000) 15(7) BIJB & FL 269; Fuller & Ranero, “Collateralised Debt Obligations” (2005) 20(9) JIBFL 343.

instruments should be regulated as securities. Whether they should be treated as traditional securities (e.g. corporate shares) or be regulated by special rules is another matter.<sup>44</sup>

In sum, the risk trading market is not directly comparable to the securities market. Although securities can be traded on or off exchanges like futures or many commodities, in the securities market the mandatory disclosure rule lies in the nature of securities and cannot be transposed seamlessly onto exchange-traded contracts under discussion in this thesis.

## 5.3 Voidable Contracts: Risk Trading and Utmost Good Faith

### 5.3.1 Background

Insurance and guarantee contracts provide a good comparison with risk trading contracts. Insurance contracts are clearly intended to cover loss from future risks.<sup>45</sup> Guarantees, on the other hand, serve the purpose of ensuring the performance of a debtor's obligation.<sup>46</sup> Interestingly, both types of contract are subject to a duty of disclosure but on different legal grounds. An insurance contract has long been labelled a contract *uberrimae fidei*.<sup>47</sup> An assured has to disclose material information to the insurer to observe the duty of utmost good faith; otherwise the contract could be avoided.<sup>48</sup>

On the other hand, there is also a duty of disclosure for contracts of guarantee or suretyship. It was stated that

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<sup>44</sup> See *Ciro*, "Game Theory in Financial Markets Litigation" (2005) 20(7) JIBLR 315.

<sup>45</sup> We have briefly discussed whether derivative instruments might be defined as "insurance". See *supra* 2.5.

<sup>46</sup> See *Moschi v Lep Air Services Ltd* [1973] AC 331 (*per* Lord Diplock). We should be aware that a guarantee contract might also be regarded as insurance if it satisfies the requirements for an insurance contract. See *Seaton v Heath* [1899] 1 QB 782, at 792-793 (*per* Romer J).

<sup>47</sup> See *Carter v Boehm* (1766) 3 Burr 1905; *Whittingham v Thornburgh* (1690) 2 Vern 206; 23 ER 734; Marine Insurance Act 1906, section 17. See also *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] 1 AC 501; *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd (The Star Sea)* [2003] 1 AC 469.

<sup>48</sup> Marine Insurance Act 1906, section 18.

“a duty was imposed by the law upon creditors to disclose, when negotiating for a suretyship contract, *all material facts*—i.e., all facts which if disclosed would tend to incline a prudent proposed surety to decline to enter into such a contract, or would tend to persuade him to ask for a greater reward for it than had previously been proposed.”<sup>49</sup>

However, a contract of guarantee is not considered a contract *uberrimae fidei*.<sup>50</sup>

It is necessary to explore what is meant by “utmost good faith” and why an insurance contract should require utmost good faith. Insurance as contracts *uberrimae fidei* can be traced back to the case of *Carter v Boehm*<sup>51</sup> in the 18th century, where Lord Mansfield stated that “[g]ood faith forbids either party, by concealing what he privately knows, to draw the other into a bargain, from his ignorance of that fact, and his believing the contrary.”<sup>52</sup> While Lord Mansfield’s attempt to establish a general requirement of good faith in the contract law failed, it nevertheless survived in insurance law.<sup>53</sup> An interesting point to note is that Lord Mansfield only used the term “good faith”, but the Marine Insurance Act 1906 regards insurance as a contract of “utmost good faith”.<sup>54</sup>

Since good faith is already a rather ambiguous concept, it is not clear what *utmost* good faith means. It has been suggested that “[t]he connotation appears to be the most extensive, rather than the greatest, good faith”.<sup>55</sup> Frequently, it is easier to identify conduct that is not in utmost good faith (or, more straightforwardly, is a case of “bad faith”) than to illustrate the concept with a positive description. The most distinguishing feature of utmost good faith is the duty to disclose

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<sup>49</sup> *Hamilton v Watson* (1845) 12 C & F 109, at 118.

<sup>50</sup> *Royal Bank of Scotland v Etridge (No 2)* [2002] 2 AC 773, at 848 (*per* Lord Scott of Foscote).

<sup>51</sup> (1766) 3 Burr 1905.

<sup>52</sup> *Id.*, at 1910. The same principle was applied to life assurance in 17th century in *Whittingham v Thornburgh* (1690) 2 Vern 206; 23 ER 734 (cited in Eggers, *Good Faith and Insurance Contracts*, at 5, fn 41 (LLP, 2004)).

<sup>53</sup> *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd (The Star Sea)* [2003] 1 AC 469, at 492 (*per* Lord Hobhouse).

<sup>54</sup> Marine Insurance Act 1906, section 17. For historical development of the concept of good faith and utmost good faith, *see* Hasson, “The Doctrine of Uberrima Fides in Insurance Law: A Critical Evaluation” (1979) 32(6) MLR 615.

<sup>55</sup> *The Star Sea*, *supra* note 53, at 492 (*per* Lord Hobhouse).

material information.<sup>56</sup> However, we should note that the duty of utmost good faith is more than just disclosure. Since it applies to both insurers and assureds, and it might thus also be used as a weapon against the insurer.<sup>57</sup> It has been held that an insurer's right to avoid a contract following non-disclosure by the assured is restricted by the duty of utmost good faith.<sup>58</sup> Thus, the duty of utmost good faith restrains the conduct of both the assured and the insurer. We should take care in drawing the line between the duty of disclosure and a more general duty of utmost good faith.

### 5.3.2 Foundation of Utmost Good Faith in Insurance Law

The inequality of knowledge is behind the doctrine of utmost good faith in insurance law.<sup>59</sup> For example, a car insurer does not normally know a car owner's complete driving record; nor could a health insurer normally know if the assured has any hidden or untold disease. Such an asymmetric spread of information could lead an insurer to underwrite a risk at too low a premium. Therefore, the insurer needs to acquire the relevant information from the assured in order to evaluate the proper level of risk exposure and determine the correct premium. However, given the direct connection between information and the level of premium he will pay, the assured has some incentive not to disclose material information to the insurer, leaving the insurer in a disadvantageous position.

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<sup>56</sup> Marine Insurance Act 1906, sections 18 & 20.

<sup>57</sup> See Lowry & Rawlings, "Insurers, Claims and the Boundaries of Good Faith" (2005) 68(1) MLR 82; Yeo, "Post-Contractual Good Faith - Change in Judicial Attitude" (2003) 66(3) MLR 425.

<sup>58</sup> See *Drake Insurance plc v Provident Insurance plc* [2004] QB 601.

<sup>59</sup> Per Lord Mansfield, "[t]he special facts upon which the contingent chance is to be computed lie most commonly in the knowledge of the insured only. The underwriter trusts to his representation, and proceeds upon confidence that he does not keep back any circumstance in his knowledge to mislead the underwriter into a belief that the circumstance does not exist, and to induce him to estimate the risk as if it did not exist. ... Although the suppression should happen through mistake without any fraudulent intention, ... the policy is void, because the risk run is really different from the risk understood and intended to be run at the time of the agreement." *Carter v Boehm* (1766) 3 Burr 1905, at 1909—1911.

A common response is to argue that non-disclosure constitutes fraud.<sup>60</sup> However, as we saw earlier, mere silence does not automatically trigger misrepresentation, mistake, or the tort of deceit (see 5.1.2 above), and it is not always clear what sort of information need or need not be disclosed to the insurer. Where the insurer makes no specific inquiry, there is no specific reason why an assured should be liable for fraud or misrepresentation. The assured might not intend to defraud the insurer, so his silence is not necessarily a misrepresentation. The situation would be trickier if the insurer makes an inquiry but the assured decides to keep silent; nevertheless, such silence is not unconditionally fraud. Undoubtedly, an assured could still be liable for concealment of information if his actions satisfy the criteria for deceit and misrepresentation. However, the problem under consideration here is the circumstance where a concealment or non-disclosure does not constitute intentional deceit or misrepresentation but still raises questions of bad faith or unfairness. The creation of the concept of “utmost good faith” could fill the gap between restrictive fraudulent laws and the common law non-disclosure rule.

Economic analysis could provide further support for some kind of disclosure requirement on the part of the assured. When insurers issue policies they calculate the premiums to reflect the true level of risk exposure, but insurance companies also try to spread the risk among other assureds falling into the same category. Premiums are calculated not only on the basis of the specific risk exposure of the assured but also on the general occurrence rate of this same risk in the market (e.g. the incidence of breast cancer among British women). Thus, the expected loss from non-disclosure by one assured could be transferred to other assureds by their being charged higher premiums than would apply in a general climate of full disclosure. In addition, full disclosure of material information by assureds might help to address the moral hazard issue created by asymmetric information.<sup>61</sup> “Adverse selection”<sup>62</sup> may occur when an insurer selects those with a good disclosure record or those relatively safe from risks as

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<sup>60</sup> Indeed, Lord Mansfield made a strong statement that “[k]eeping back such circumstance is a fraud”. *Id.*

<sup>61</sup> *Id.*, at 50.

<sup>62</sup> Cooter & Ulen, *Law and Economics*, at 51 (3rd ed., Addison-Wesley, 2000).

the target group for insurance rather than underwriting risks from the wider public. This may result in high-risk groups (usually those who need more protection from insurance) being excluded from enjoying the benefits of insurance. However, while economic analysis may provide some explanation of the *raison d'être* of the insurance disclosure rule, it does not explain why “utmost good faith” is required.

The same grounds could also be used to explain why a contract of guarantee is not a contract *uberrimae fidei*. The scope of the guarantee disclosure is rather limited. In Lord Campbell’s words, the criterion is:

“whether there is anything that might not naturally be expected to take place between the parties who are concerned in the transaction, that is, whether there be a contract between the debtor and the creditor, to the effect that his position shall be different from that which the surety might naturally expect; and, if so, the surety is to see whether that is disclosed to him.”<sup>63</sup>

Indeed, the information problem that arises with a guarantee is not the same as that in insurance. The creditor (like an assured) does not necessarily have an advantage in acquiring credit information about the guarantor. In addition, since no premium is paid between guarantor and creditor, there is no further economic implication to protect other creditors (like assureds). This also opens the door to examine the debtor-guarantor relationship and issues relating to duress and undue influence in order to explain why guarantors choose to absorb the debtor’s credit risk.<sup>64</sup> If, as Lord Campbell suggests, a creditor should only disclose information that could make the guarantee or suretyship different from what he might naturally expect, misrepresentation or even mistake might be a better explanation.<sup>65</sup>

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<sup>63</sup> *Hamilton v Watson* (1845) 12 Cl & Fin 109, at 118-119 (*per* Lord Campbell), quoted in *Levett v Barclays Bank plc* [1995] 1 WLR 1260, at 1276.

<sup>64</sup> See *Royal Bank of Scotland v Etridge (No 2)* [2002] 2 AC 773; *Barclays Bank plc v O'Brien* [1994] 1 AC 180.

<sup>65</sup> Vaughan Williams LJ took the view that “a creditor must reveal to the surety every fact which under the circumstances the surety would expect not to exist, for the omission to mention that such a fact does exist is an implied representation that it does not”: *London General Omnibus Company Ltd v Holloway* [1912] 2 KB 72, at 79.

Moreover, in the modern era, the concept of “utmost good faith” serves other purposes than merely dealing with the inequality of knowledge. One area stressed by case law is the element of “fair dealing” in a duty of utmost good faith.<sup>66</sup> To some extent, the duty of disclosure could be reconciled with the idea of fair dealing as one might argue that it is unfair for the assured to conceal material information from the insurer.

However, it is easier to show that utmost good faith entails “fair dealing” than the other way round. There is always a certain degree of “fair dealing” in every transaction, yet those commercial transactions are not treated as contracts of utmost good faith. In modern times, when insurance companies are generally more powerful than most assureds, it is also more difficult to base the duty of utmost good faith on the ground of fair dealing and impose a heavier duty of disclosure on the assured, who has less bargaining power.

Lastly, requiring the assured to disclose material information is one thing, but determining the materiality is another. It could be linked to as an assured’s duty to disclose or not to conceal information when the insurer makes an inquiry. Given that modern insurers are generally more expert at their business than assureds, an insurer should, in general, have a better idea of what information is required. Thus, there is a trend in insurance law to impose more responsibility on the insurer to make inquiry rather than relying on the assured to disclose information.<sup>67</sup> The development of the duty of disclosure in insurance law is a topic of its own and we need not enter into details here. However, it is important to note that bargaining power and fair dealing arguments can be incorporated into the discussion of the duty of utmost good faith.

Two conclusions may be drawn from the above discussion. First, it is the inequality of knowledge between assured and insurer regarding insured risks that is behind the duty of utmost good faith and the duty of disclosure in insurance

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<sup>66</sup> *The Star Sea*, *supra* note 53, at 491–495 (*per* Lord Hobhouse); *see also* *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] 1 AC 501.

<sup>67</sup> *See generally*, Tarr, *Disclosure and Concealment in Consumer Insurance Contracts* (Cavendish, 2002); Tarr & Tarr, “The Insured’s Non-Disclosure in the Formation of Insurance Contracts: A Comparative Perspective” (2001) 50(3) ICLQ 577.



law. The duty of utmost good faith could fill in the gap left between fraud laws and the common law non-disclosure rule. Secondly, the duty of good faith has a modern application in addressing the inequality of bargaining power and issues of fair dealing, notably in restricting the advantages of powerful insurers. It is on this ground that we will proceed with our arguments for the use of utmost good faith in risk trading contracts.

### **5.3.3 Risk Trading and Utmost Good Faith**

#### **5.3.3.1 Exchange Trading**

Let us start with exchange trading contracts. As the analysis in Chapter 3 showed, exchange-futures contracts are highly standardised such that the exchange contract has become the subject matter of trading instead of the underlying commodity (see 3.2 above). Since exchange contracts are so standardised, futures trading does not involve a lot of negotiation of terms, except prices and the number of contracts. There is no inquiry and no concealment as traders are not expected to ask or disclose anything other than the desired trading price and the number of contracts on the trading floor or in the computer system. Any disclosure, if required, should be made to the exchange rather than to the counterparty during trading. Thus, it would be meaningless to argue that an exchange contract requires utmost good faith. In contrast, since a trader must have a membership agreement with the exchange and a non-member must have a brokerage or similar agreement with an exchange member, the issue of disclosure in the exchange market could be analysed as a matter of post-contractual disclosure.

It is undeniable that we expect some form of good faith in exchange trading, much as we do in the cases of other commercial contracts. Most traders hope the prices on the market are reliable and reflect the current state of the market or expectations, so they do not want instances of market manipulation or insider dealing. If market manipulation and insider dealing are important concerns, we have to consider whether it is better to address these problems with special rules rather than imposing a general duty of utmost good faith on all futures trading.

Given that there are many kinds of futures contracts and traders in the market, a general duty of utmost good faith might in turn make futures transactions fiduciary relationships, a situation that even the securities market has not yet reached.

### **5.3.3.2 Over-the-Counter Trading**

In relation to the over-the-counter (OTC) market, the issue of good faith could be examined from several perspectives. The complexity of hedging products and the fast-changing environment of the market makes it difficult to reach a single and definitive conclusion on all off-exchange transactions. However, until off-exchange hedging contracts become more consumerised, there is no need to use the concept of “utmost good faith” to address the information problem. Instead, it is more likely that issues of insider dealing or market manipulation will be introduced.

Let us examine the nature of risks and their evaluation in the case of an insurance contract and OTC derivative instruments. In the case of insurance, one may argue that the evaluation of risk exposure is to a certain extent individualised.<sup>68</sup> For example, the determination of the correct premium level for a motor insurance contract depends partly on the driving record of the driver. For health insurance, the insurer needs to know the health condition of the assured in order to calculate how much risk he is exposed to. But this information might not be accessible to the insurer without the assured’s disclosure and, even with some kinds of standardisation in effect, when issuing a policy the insurer still has to know some of the assured’s personal information.<sup>69</sup> Thus, there is a larger margin for the assured to exploit the insurer’s lack of knowledge.

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<sup>68</sup> Schwartz, “Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation” (2007) 12 *Fordham J Corp & Fin L* 167, at 191 (citing Keeton and Widiss, *Insurance Law: A Guide to Fundamental Principles, Legal Doctrines and Commercial Practices*, at 164-72 (Practitioner’s ed. 1988))

<sup>69</sup> It has also been argued that marine insurance still relies on individualised calculation of risks and negotiation. See Schoenbaum, “The Duty of Utmost Good Faith in Marine Insurance Law: A Comparative Analysis of American and English Law” (1998) 29 *J Mar L & Com* 1, at 3–4 and notes 13 & 14.

In contrast, the personal element seems to be much diluted in derivative instruments. For market hedging, the risk exposure comes from the fluctuation of the market, which in principle should be external to the control of any risk seller or risk buyer (*cf.* assureds and insurers, respectively). The evaluation of market risk does not depend on the risk seller's special knowledge as market data is, in theory, open to all traders to discover. Thus, risk sellers do not necessarily have better knowledge than risk buyers.<sup>70</sup> A risk buyer might even have equal or better access to information than a risk seller, so there is no apparent inequality of knowledge in the derivatives market similar to that in the insurance market.

The same could also be argued for standard credit derivatives (see 2.2.2.3 above). In a typical credit default swap (CDS), the risk seller tries to transfer to the risk buyer the credit risk of the bonds or other credit instruments he holds. Risk buyer and the risk seller probably have equal access to information concerning the credit risk of the third party issuer.<sup>71</sup> So, the basic inequality of knowledge issue does not necessarily arise.

However, the above analysis is based on an assumption that market or credit risks are foreign to both hedgers and speculators, whether they are risk buyers or sellers—if they have equal access to the information, there seems to be no need to ask one party to disclose to the other. Nevertheless, there are some circumstances where this assumption might be false. First, with the advancement of financial engineering, a derivative transaction might be designed so as to incorporate a party's personal traits. For example, there exists the so-called “self-linked” credit derivative, where the risk seller actually sells his own credit risks or those of persons connected to him (e.g. a parent company or a subsidiary).<sup>72</sup> This may resemble insurance in some aspects because risk buyers for such credit derivative instruments might not know as much as the risk seller with regard to the credit risk of the reference entity.

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<sup>70</sup> Save for the situation where the risk seller himself generates information that could influence the market.

<sup>71</sup> This is based on an assumption that both the risk buyer and the risk seller are business entities and are generally equal in capacity of making business or financial judgments.

<sup>72</sup> See Firth, “Self-referenced Credit Derivatives—Are They Enforceable under English Law?” (2006) 1(1) CMLJ 21.

Secondly, where one person conducts a market manipulative scheme to work the market to his favour, to some extent, he has better knowledge of potential market fluctuation than other traders (because he causes it). “Moral hazard” problems might also arise for credit derivative transactions, where the risk buyer “manufactures” a credit event in his favour.<sup>73</sup> It has happened that a lender, purchasing credit default swaps to protect against the credit risk of the loans made to borrowers, intentionally restructured the loans to trigger the payment obligation of a CDS.<sup>74</sup> To date, credit derivatives transactions are conducted mainly between banks and financial or business entities. Thus, concerns about moral hazard might be reduced because the risk buyer is usually capable of spotting potential problems and protecting himself contractually. However, as the design of derivative instruments becomes more personalised, this will create asymmetric information and moral hazard problems similar to those of the insurance field.

Thirdly, where a trader is a corporate insider who has more inside knowledge than other traders, this creates a situation similar to insider dealing in the context of securities laws. Arguably, there could be unequal accessibility to information (even for a short period of time). As to the hedging market, potential insider dealing could be solved by extending the insider dealing rule commonly seen in securities regulation. We will address this issue later in this chapter.

Fourthly, one day, risk trading products might become more consumerised, which is to say they will be sold to individual consumers rather than to more sophisticated business entities. The resultant inequality of bargaining power might imply an inequality of information about products, the market and the underlying risks. Thus, one could make a further argument to support the imposition of a “good faith” duty upon the stronger side. However, we should be aware that in a typical insurance context it is the assured (usually having less bargaining power) who possesses useful information, rather than the insurer (who

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<sup>73</sup> See Bezzina, “The Protection Seller's Scylla and Charybdis: Negotiating the Moral Hazard Straits in ISDA -based Cash-settled Credit Default Swaps” (2005) 20(11) JIBLR 600.

<sup>74</sup> Das, *Structured Products Volume 2: Equity; Commodity; Credit & New Markets*, at 743–744 (3rd ed., rev edn, John Wiley & Sons, 2006).

usually has greater bargaining power). If the risk trading market becomes more consumerised, it would be the product seller who had better knowledge and expertise rather than individual consumers. This could necessitate further duties on the part of financial promoters, or raise so-called “suitability” issues (see also 2.3.3 above).

The above discussion shows that it would be inappropriate to reject the idea of the contract *uberrimae fidei* merely on the basis of the argument that the risk evaluation of derivative instruments is not individualised. There are indeed circumstances that in which information is asymmetric and moral hazard problems arise, as in insurance law.

However, imposing a duty of utmost good faith is only one of the possible ways to deal with potential information problems. There may be some instances of “bad faith” trading or concealment that could damage the market and investors. The question we face here is how far the problem could be addressed by a duty of utmost good faith or a duty of disclosure. If breaching a duty of utmost good faith results in a contract being avoided (as in section 17 of the Marine Insurance Act 1906), the significant legal consequences and legal uncertainties involved might not justify the benefits accruing from such a duty. Avoiding contracts requiring only a single performance (like options) is relatively easy to tackle. However, where there are multiple performances (like an interest rate swap), avoiding contracts may create complicated restitution issues, like the series of local authority cases that arose in the UK (see 2.3.1 above), especially when the contract has run some time for part of its term. As OTC documentation grows more complicated, breaking the contractual scheme might lead to more problems than solutions.

In addition, several regulatory regimes already exist to deal with these issues. Market manipulation and insider dealing are already punishable by statutes. To some extent, problems may be solved contractually.<sup>75</sup> We should also consider whether courts are better equipped to decide market manipulation and price

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<sup>75</sup> See Bezzina, *supra* note.73; Edwards, “The Law of Credit Derivatives” (2004) JBL 617, at 646.

issues (if we take the good faith approach), rather than relying on regulators or other professionals. There is still room for development.

In sum, it is too much to argue that all OTC derivative transactions should be treated as kinds of contracts of utmost good faith. Most instruments lack the personal element that we have seen in the case of insurance policies. Even for those instruments which have some degree of personalisation and require a certain amount of good faith before the contract is made, it is arguable that there are other better ways of dealing with them than imposing a duty of utmost good faith and avoiding a contract for failure to honour such duties. After all, derivative instruments are based on contracts. If one party believes that a certain type of information is important, he might simply ask the other party about it or insert a special term to address the issue. If no inquiry is made and no such term inserted, why should we not rest with: *let the buyer be aware?*

### 5.3.3.3 Guarantee and Credit Default Swap

Lastly, let us consider the case of applying a duty similar to a guarantee contract to particular credit default swaps (CDS).<sup>76</sup> As mentioned earlier, a guarantee contract and a standard CDS share some similarities as they both deal with the credit default of a debtor, where a guarantor, as a secondary debtor, pays off the debts of the principal debtor.<sup>77</sup> In a credit default swap, a risk buyer compensates the loss in value, usually by way of repaying to the risk seller the difference between the par value of the debt instrument (bonds or loans) and its current market price after default or by buying out the debt instrument from the risk seller. In this way, a CDS ensures that a bondholder (or the lender of a loan) can reclaim back the money to which he is entitled. If a guarantor has a claim on avoiding his guarantee contract when the principal debt is greatly different from what he knew,<sup>78</sup> could a risk buyer in a CDS enjoy the same claim?

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<sup>76</sup> The operation of a credit default swap was explained in section 2.2.2.3.

<sup>77</sup> For more thorough analysis of the accessory nature of a guarantee contract, see Steyn, "Guarantees: the Co-existensiveness Principle" (1974) 90 LQR 246.

<sup>78</sup> See supra 5.3.1. Cf. *Associated Japanese Bank (International) Ltd v Credit du Nord SA* [1989] 1 WLR 255.

In reality, it is rather unlikely that a risk seller would agree to take on the credit risks of a third party unless the instrument(s) requiring hedging were specified.<sup>79</sup> This would have two kinds of effects. On the one hand, since it is specified, the risk buyer just has to perform the contract as it is. If the risk buyer decides to take the credit risks associated with Bond A and if, unfortunately, Bond A is in default, the risk buyer should bear the fruits. It does not matter if the risk seller does not hold any Bond A or if he holds Bond B instead of Bond A as stated in the agreement.

On the other hand, a CDS could be synthetic or purely speculative (meaning no loans or bonds are actually held). In the case of a guarantee, such kinds of disclosure are important and necessary because the guarantor's obligation is closely linked to the principal obligation. If the principal obligation differs from what was agreed at the beginning, the extent of the guarantor's secondary obligation changes accordingly. The same rationale regarding disclosure does not hold in the case of a CDS. This does not mean that a risk buyer has no claim if the underlying credit obligation greatly exceeds what was expected—he may be able to seek remedies using the doctrine of mistake or misrepresentation. It is simply that guarantees and CDS are not comparable in terms of pre-contractual disclosure issues.

### 5.3.3.4 Summary

In this part, we focused on the issue of whether risk trading contracts could be seen as another type of contract *uberrimae fidei* in which a duty of utmost good faith dictates a duty of disclosure. Apart from definitional issues relating to insurance and derivatives, we found that it would be difficult to extend the sort of duty of utmost good faith applied in insurance to the derivatives market. The inequality of knowledge that underlines the insurance disclosure rule does not

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<sup>79</sup> This would be the case of a CDS being used to cover credit exposure on bond or loan. But if a CDS structure is employed to address the credit risk of another derivative transaction (e.g. an interest rate swap), the CDS then becomes a “swap guarantee” or a “market risk contingent credit default swap”. In this situation, the credit exposure that underlies the CDS becomes more dynamic than that of a conventional CDS. See Das, *Credit Derivatives: CDOs & Structured Credit Products*, at 156–158 (3rd ed., John Wiley & Sons, 2005).

necessarily exist in the case of other hedging instruments. We failed to find significant differences between derivative instruments and other commercial contracts, which have no utmost good faith requirement. However, we also noted that problems similar to those found in insurance may arise in the risk trading market if an instrument is linked to the risk buyer himself. More problems may arise as the market becomes more consumerised and individualised. Some of these issues could be resolved by further examination of contractual parties rather than by the nature of the contract itself.

## 5.4 Special Relationship

Following above analysis, we will further examine whether there is a kind of special relationship between parties to a derivative transaction. We will start by discussing the use of contracts to control disclosure issues before a specific transaction is made. We will then consider whether the relationship between the two parties is of a kind that could raise a fiduciary relationship such that one party would have to disclose to the other party certain information in order to observe his fiduciary duties.

### 5.4.1 Risk Trading and Fiduciary Relationship

Let us first determine whether risk trading contracts can automatically entail fiduciary duties such that one party (as a fiduciary) has to disclose material information to the other party before a transaction. Not every type of relationship is of the kind of fiduciary in nature. In general,

“[t]he paradigm of the circumstances in which equity will find a fiduciary relationship is where one party, A, has assumed to act in relation to the property or affairs of another, B. A, having assumed responsibility, pro tanto, for B's affairs, is taken to have assumed certain duties in relation to the conduct of those affairs, including normally a duty of care.”<sup>80</sup>

Fiduciary duties usually arise in a situation where one person is required to take care of the interests of another person or persons and where we expect him not to

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<sup>80</sup> *White v Jones* [1995] 2 AC 207, at 271 (*per* Lord Browne-Wilkinson).



advance his own interests before those of the other party or parties.<sup>81</sup> Three types of relationships exemplifying the fiduciary relationship are the trustee-beneficiary relationship, principal-agent relationship, and director-company relationship. Trustee, agent, and corporate director have to serve the best interests of the beneficiary, the principal, and the company respectively.

Once a fiduciary relationship is proven to obtain, fiduciary duties consist of at least two aspects. On the one hand, “[t]he distinguishing obligation of a fiduciary is the obligation of loyalty”;<sup>82</sup> thus, the fiduciary should not put himself in a position creating a conflict of interest with the other party or put his own interests ahead of the other party’s. On the other, a fiduciary owes a fiduciary duty of care to serve the benefits of the other party, the exact scope of which duty of care depends on the relationship between the two parties. The reasonable care expected of a corporate director might not be the same as that expected of the trustee of an estate; thus, the extent of a fiduciary duty of care should be decided on a case-by-case basis.<sup>83</sup> However, as far as information and disclosure are concerned, it may be argued that to observe his duty of care or to avoid a conflict of interest the fiduciary might have to disclose certain material information to the other party prior to a specific transaction.<sup>84</sup> The duty to report is also embedded in fiduciary relationship.<sup>85</sup>

The key is still to establish a fiduciary relationship in the first instance.<sup>86</sup> It should be noted that a bank-customer relationship is generally not considered a

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<sup>81</sup> According to Finn, “the central idea [of fiduciary duties] is service of another’s interests.” Finn, “Fiduciary Law and the Modern Commercial World” in McKendrick (ed.), *Commercial Aspects of Trust and Fiduciary Obligations*, at 9 (OUP, 1992).

<sup>82</sup> *Bristol and West Building Society v Mothew* [1998] Ch 1, at 18 (*per* Millett LJ).

<sup>83</sup> *Per* Lord Browne-Wilkinson, “[a]lthough the extent of those fiduciary duties (including duties of care) will vary from case to case, some duties (including a duty of care) arise in each case.” *White v Jones*, *supra* note 80, at 271.

<sup>84</sup> *See Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134. The FSA has made detailed rules in what a regulated person should do to cope with conflict of interest, including disclosing his interests to his client. *See* FSA Handbook, COB 7.1.

<sup>85</sup> *See Leitch v Abbott* (1886) 31 ChD 374. *See also* Restatement of Law 2d, Agency, section 381.

<sup>86</sup> Nevertheless, to determine whether a person is fiduciary, we might have to resort to the nature of the fiduciary duties. In Finn’s words, “[i]t is not because a person is a ‘fiduciary’ or a ‘confidant’ that a rule applies to him. It is because a particular rule applies to him that he is a

fiduciary relationship but only a contractual one.<sup>87</sup> However, it has been suggested that where a situation involves the trust and confidence of one party or where there is an assumption of responsibility, special relationships other than trust and agency might raise a fiduciary duty of care.<sup>88</sup> The US law also takes a similar position.<sup>89</sup>

Despite the fact that there is no clear definition of fiduciary relationship, we could draw a tentative conclusion that a fiduciary relationship requires “trust and confidence”. From this point of view, it is clear that derivative instruments alone do not generally create the kind of relationship requiring trust and confidence. It is not in the nature of these instruments to require authority, management, or forwarding other people’s best interests; neither does insurance or a sale. Thus, we could conclude that a risk trading contract does not automatically raise fiduciary duties. This is also the position taken by US judges to date.<sup>90</sup>

This thesis does not argue that a fiduciary relationship may never arise between any given two parties. A fiduciary relationship may be established if a trust and confidence relationship is proved, but this could only be decided on a case-by-case basis. What we argue in this section is that risk trading contracts alone do not necessarily entail fiduciary duties, but we do not exclude the possibility that fiduciary duties might arise from the two parties’ other dealings.

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fiduciary or confidant for its purposes.” Finn, *Fiduciary Obligations*, at 2 (Law Book Company, 1977). See also *Bristol and West Building Society v Mothew* [1998] Ch 1, at 18 (*per* Millett LJ).

<sup>87</sup> See generally Hudson, *Law on Financial Derivatives*, at 7-30 (4th ed., Sweet & Maxwell, 2006). See also *Foley v Hill* [1848] 2 HLC 28. In *National Westminster Bank plc v Morgan* [1985] AC 686, the court held that a bank-customer relationship was not the kind of ordinary relationship that raised the presumption of undue influence. At 707 (*per* Lord Scarman).

<sup>88</sup> *White v Jones* [1995] AC 207 (*per* Lord Browne-Wilkinson). See also *Woods v Martins Bank Ltd* [1959] 1 QB 55; *United Pan-European Communications NV v Deutsche Bank AG* [2000] EWCA Civ 166.

<sup>89</sup> See *De Kwiatkowski v Bear, Stearns & Co, Inc*, 306 F 3d 1293 (2002); *K3C Inc v Bank of America*, 2006 US App LEXIS 27437.

<sup>90</sup> In *Lehman Brothers Commercial Corp v Minmetals International Non-Ferrous Metals Trading Co*, a US judge also held that “a fiduciary duty does not arise in the normal course of an arm’s-length business transaction. ... [C]ourts have held that a financial products dealer ... normally does not undertake a fiduciary duty when it acts as a principal in transactions with an institutional counterparty in which no trading discretion is conferred.” 179 F Supp 2d 118, at 150 (2000).

## 5.4.2 Fiduciary Duties and Exchange Brokers

Further to the above discussion, let us consider the relationship between an exchange broker and his client. As described in Chapter 3, traders who are not members of an exchange have to go through a firm or a person who is a member and who will place trades for him. Usually the member trades on his own account, even though he is receiving orders from a customer. Therefore, although it may look as if the customer is trading on the futures market through a brokerage firm, there are, in fact, two parts to the transaction: one between the member firm in the exchange, and the other between the firm and the customer. For convenience, we may loosely call the member firm a “broker”.<sup>91</sup> In this context, we may approach the information issue in several ways.

First, information could move from either side of the broker-client relationship. On the one hand, if the client holds material information that is unknown to the broker, this situation is similar to those we discussed in the previous sections. Since a customer could hardly be treated as a fiduciary to the broker, it would be difficult to require the client to disclose on the grounds of fiduciary duties.

On the other hand, the analysis will be different if it is the broker who holds material information and does not tell the client before the latter places an order. Since a broker deals with the customer’s orders, an agency relationship could obtain between them that might raise fiduciary duties.<sup>92</sup> Even without financial regulation of the behaviour of financial brokers (if they are regulated persons),<sup>93</sup> there are certain common law rules on the relationship between parties as to the handling of orders and the movement of money or properties.<sup>94</sup> Thus, there is the possibility of raising fiduciary duties to deal with information issues in the

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<sup>91</sup> An exchange member could hire another exchange member to trade for him. A specialist floor trader might also conduct trades for another member firm. The relationship in these situations is similar to a broker-client relationship. *See also supra* 3.2.1 for different types of market participants in the exchange market.

<sup>92</sup> In *Brandeis Brokers Ltd v Black* [2001] 2 Lloyd’s Rep 359, Toulson J upheld the decision of arbitrators that Brandeis had an agency relationship (and thus fiduciary relationship) with Black, his client, even when Brandeis traded in the futures market as an undisclosed principal (for a discretionary account of Mr. Black). *See infra* 5.5.2.2 for more details of this judgment.

<sup>93</sup> For example, the FSA Handbook, COB 7 provides some rules to regulate how a broker/dealer should deal with a customer’s order

<sup>94</sup> *See Stafford v Conti Commodity Services Ltd* [1981] 1 Lloyd’s Rep 466.

broker-client relationship. It then depends on the scope of the duties owed by the broker. If a broker only handles orders for the client without giving any advice or being given any discretion, it is arguable whether the duty of the broker could include informing the client as to a piece of material information.<sup>95</sup> In contrast, if the client has authorised the broker to use his discretion when trading, there is a higher chance that the broker is under a duty to disclose relevant market information.<sup>96</sup>

Secondly, in a broker-client relationship, further bargaining power and investor protection concerns could arise. A client could be a sophisticated business entity who does not have membership in an exchange. He could also be an individual investor who wishes to hedge or speculate in the futures market. Thus, it would be false to assume that there is always unequal bargaining power between a broker and a client. On the other hand, the contract between a broker and a client could be a standardised form drawn up by the broker without any negotiation. Further concerns might come into play if a broker has greater bargaining power, which allows him to insert terms necessary to protect him from any information advantage.<sup>97</sup>

Thirdly, it would be a different story if a broker assumed the role of an investment adviser rather than merely a broker. It would be even more complicated if we took into account the law of negligence and the potential duty of confidentiality owed by the broker, who might have to take care in drafting his contract and in the wording of his advice to customers to avoid any exposure to liability.

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<sup>95</sup> In *De Kwiatkowski v Bear, Stearns & Co, Inc*, 306 F 3d 1293 (2002), the US court took the view that a broker for a non-discretionary account does not normally hold any fiduciary duty or additional duty to disclose to or advise his client.

<sup>96</sup> *Cf. Brandeis Brokers Ltd v Black* [2001] 2 Lloyd's Rep 359.

<sup>97</sup> A similar line of analysis was taken in the US law. The client's level of sophistication is an essential factor when determining whether there is a fiduciary relationship between a broker and a client. See Matthews, "Derivatives, Fiduciary Obligations and Codes of Conduct" in Bettelheim, et al. (ed.), *Swaps and Off-exchange Derivatives Trading: Law and Regulation* (FT Law & Tax, 1996).

## 5.5 Insider Dealing

If the above analysis shows that the mandatory disclosure system in securities regulations might not work well in the non-securities market, and that the duty of utmost good faith is not suitable for non-insurance risk trading contracts, there is still one type of non-disclosure that might be seen as wrong but is not addressed by common law remedies. Insider dealing (also called “insider trading”) has long attracted academic interest. The insider dealing rule does not directly impose a duty of disclosure; instead, the insider dealing rule prohibits an insider from using his information advantage before the information has been published in a proper manner. The rule is largely based on statute.

An insider dealing transaction is a transaction where an “insider” uses his privileged access to inside information to make profit on the market before this information is disclosed to the public. Insider dealing problems are usually discussed in the context of securities markets. For example, a typical case of insider dealing in the securities market would be if a director at Northern Rock sold his shares in the company ahead of a new financial report on Northern Rock’s performance, being aware that the report is much worse than the market expected. If, in contrast, he chooses to go long or short on NASDAQ futures, he is still profiting from his inside knowledge but he has crossed the line into the derivative market.

The same thing could also happen in the commodities market. Broadly speaking, any information advantage could lead to some kinds of insider dealing, whether it is related to securities or not. If the opportunistic buyer in *Laidlaw v Organ* had been the agent of one of the representatives signing the peace treaty, he would have been using insider information for his own profit. Osama Bin Laden could likewise have made huge profits by making currency or oil transactions before or after the September 11 attack (if he had found a way to launder his money). Or, to give a rather more cinematic example, a person gifted with supernatural powers over the weather (such as in the movie *X-Men*)

could earn a fortune simply by buying weather futures and using his powers to change weather patterns to his own advantage.<sup>98</sup>

Given the speculative nature of derivative instruments and the close connection with current financial markets, it is no surprise that insider dealing might extend from the traditional securities market to futures or other derivatives markets (see 5.5.1 below). However, it is not clear how far the insider dealing rule should and could address potential information problems. In this part, we will examine potential insider dealing problems by using derivative instruments. We will not limit ourselves to a narrow meaning of “insider dealing” in the stock market. In contrast, we will explore a broader range of circumstances wherein a person uses his inside knowledge unknown to other market participants to conduct risk trading.

### 5.5.1 Current Laws and Underlying Theories

Before moving on to some potential insider dealing problems in the hedging market, we should first understand what insider dealing means and, more importantly, why insider dealing is deemed wrong in the securities market. In the UK, insider dealing was already considered a criminal offence under the Criminal Justice Act 1993 (CJA 1993)<sup>99</sup> before the Financial Services and Markets Act 2000 (FSMA 2000) made it a kind of “market abuse”.<sup>100</sup> We should be aware that the CJA 1993 uses explicit terms like “insider” and “inside information” and limits criminal liability to dealings with securities, which include not only stock and bonds but also options, futures, and contracts for differences involving purchases or sales of securities.<sup>101</sup> On the other hand, the

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<sup>98</sup> Similar things could also happen to gambling contracts. For example, a horse owner knows that his horse has absolutely no chance of winning a race, (for a reason not yet known to the public and which could influence the odds). Before the information is leaked, the owner could lay (or sell) odds in a betting exchange (see 4.2.1 above) and thus win some money. In this horseracing story, the owner (as one party to a gambling transaction) knows something that is not known to the other party. The owner is apparently an insider and he uses his information to his advantage before the information becomes known to the other. The question is whether the owner has to disclose this information and whether, as far as our argument in this section is concerned, this is the kind of transaction that could be defined as a type of “cheating”.

<sup>99</sup> Criminal Justice Act 1993, section 52 *et seq.*

<sup>100</sup> FSMA 2000, section 118 *et seq.* See also FSA Handbook, MAR 1.3 (insider dealing).

<sup>101</sup> Criminal Justice Act 1993, Schedule 2.

FSMA 2000 has a broader application without specific reference to “securities” or “insider”.<sup>102</sup> The FSMA 2000 makes it clear that the penalty imposed for market abuse does not make a transaction void or unenforceable.<sup>103</sup> Thus, insider dealing behaviour does not render a transaction void. However, the Financial Services Authority (FSA) might make a restitution order where necessary<sup>104</sup> and impose penalties for violators.<sup>105</sup>

In contrast, US law shows a different style. The foundation of the modern insider dealing rule in the US securities regulations lies in the anti-fraud provision in the Securities Exchange Act of 1934<sup>106</sup> and the SEC Rule 10b-5<sup>107</sup>, which make it unlawful to employ any manipulative or deceptive device (or any device, scheme, or artifice to defraud) in contravention of SEC rules and regulations. Thus, the US insider dealing law has a strong reference to “fraud”, without explicitly using the term “insider dealing” (or “insider trading”).

A breakthrough in insider dealing law occurred in the 1960s. The rule was largely developed by the Securities and Exchange Commission (SEC) and the US courts.<sup>108</sup> We should be aware that violation of the anti-provision of the Securities and Exchange Act of 1934 might grant victims private cause of actions to sue for damages.<sup>109</sup> A corporate director or officer might also have to disgorge his profits to the issuer company if he uses inside information to make profit.<sup>110</sup>

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<sup>102</sup> FSMA 2000, section 118. The FSA handbook broadly refers to insider dealing of “qualifying investment”, defined by the Treasury as all investments prescribed by the FSMA 2000 section 22 in recognised investment exchanges. See FSA Handbook MAR 1.3 and The Financial Services and Markets Act 2000 (Prescribed Markets and Qualifying Investments) Order 2001 (SI 2001/996), article 4 & 5.

<sup>103</sup> FSMA 2000, section 131.

<sup>104</sup> FSMA 2000, section 382 *et seq.*

<sup>105</sup> FSMA 2000, sections 123 & 129.

<sup>106</sup> Securities Exchange Act of 1934, section 10(b). 15 USCA 78j.

<sup>107</sup> 17 CFR 240.10b-5.

<sup>108</sup> See *In re Cady, Roberts & Co*, 40 SEC 907 (1961); *SEC v Texas Gulf Sulfur Co*, 401 F 2d 833 (1968).

<sup>109</sup> See *Superintendent of Insurance of New York v Bankers Life & Casualty Co*, 404 US 6 (1971); *Ernst & Ernst v Hochfelder*, 425 US 185 (1976).

<sup>110</sup> 15 USCA 78p(b). This section applies to corporate directors and officers when they use inside information to buy securities or securities-related instruments and when profits are realised within 6 months. The purpose of this section is to prevent “unfair” use of information.

Regardless of the meaning of “inside information”,<sup>111</sup> the meaning of “insider” appears to determine how far insider dealing rules in the securities market can reach. Corporate directors, managers and employees are the most usual type of “insider”.<sup>112</sup> In both the UK and the US, a tippee, who receives tips from corporate insiders, is also liable for insider dealing.<sup>113</sup> We also expect professionals (such as solicitors or accountants) who have access to inside information not to use it before it is published.<sup>114</sup>

However, there are always some difficult boundary cases. In *US v Chiarella*<sup>115</sup>, the court faced a situation where an employee of a financial printer somehow decoded the messages as to the target companies of takeover bids using his own skills. Should Mr. Chiarella be liable even though he was neither a corporate insider nor a professional? He did not even have a direct contractual relationship with the company (but only with his immediate employer).

This case raised a fundamental problem: why is insider dealing prohibited? One fundamental difficulty in forming the foundation for prohibition of insider dealing is identifying the victims. The victims of an insider dealing scheme could be the company itself, shareholders, counterparties to the trading contracts, other outside investors, or the market in general. For each type of victim one might develop a theory to justify insider dealing rules. This thesis does not claim to specialise in insider dealing theory, but it is necessary to understand certain concerns about insider dealing before continuing our analysis.

First, the special relationship between parties (notably the fiduciary relationship) is the basis of the insider dealing rule; thus, insider dealing might be seen to be wrong because the insider breaches his duty.<sup>116</sup> The drawback of this approach is obvious, as it cannot explain the application of the insider dealing rule beyond

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<sup>111</sup> See Criminal Justice Act 1993, section 56. It is also frequently called non-public material information in US judgments.

<sup>112</sup> Criminal Justice Act 1993 s 57(2)(a)(i). See also *SEC v Texas Gulf Sulfur Co*, 401 F 2d 833 (1968).

<sup>113</sup> Criminal Justice Act 1993, section 57(2)(b). For US law, see *Dirks v SEC*, 463 US 646 (1983); *Carpenter v US*, 484 US 19 (1987).

<sup>114</sup> Criminal Justice Act 1993, section 57(2)(a)(ii). For US law, see *US v O'Hagan*, 521 US 642 (1997).

<sup>115</sup> 445 US 222 (1980).

<sup>116</sup> *In re Cady, Roberts & Co*, 40 SEC 907 (1961).



corporate directors and professionals (e.g. why a tippee is liable for insider dealing). Secondly, a wider view is that the insider misappropriates information that does not belong to him.<sup>117</sup> Further development of this line of thinking could extend to render the tippee liable.<sup>118</sup> Thirdly, one may further argue that inside information is a kind of protected property, such that an insider should not use it without the information having already been disclosed.<sup>119</sup>

Fourthly, if we look at the bigger scale, insider dealing might have implications for the market. Price and market efficiency are major concerns. There are already plenty of economic arguments about how quickly information can be reflected in the market in terms of price and how insider dealing influences the price of securities.<sup>120</sup> On the other hand, there are also arguments to the contrary, with some authors arguing that insider dealing might in fact push price toward a more accurate position.<sup>121</sup> If price is the major concern, it is the market and investors as a whole that are the victims. In contrast, it is arguable that it is the issuing company (whose information is exploited by the insider before being published) that is the victim because its information is misappropriated. But it is also arguable whether the company suffers any loss at all in this circumstance.

Fifthly, some commentators turn to a moral explanation of why insider dealing is wrong. In *Chiarella*, Justice Blackmun argued that insider dealing without disclosure is “inherently unfair”.<sup>122</sup> However, justifying the “fairness” argument also requires much deeper analysis than a mere statement that insider dealing is unfair.<sup>123</sup> The appeal of moral theories might lie in their flexibility; however, upon closer inspection such appeal may be found rather hollow because

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<sup>117</sup> *US v O'Hagan*, 521 US 642 (1997).

<sup>118</sup> See Cohen, “Old Rule, New Theory: Revising the Personal Benefit Requirement for Tippee/Tippee Liability under the Misappropriation Theory of Insider Trading” (2006) 47 BC L Rev 547.

<sup>119</sup> See Krawiec, “Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age” (2001) 95 NW UL Rev 443; Lee, “Fairness and Insider Trading” [2002] Colum Bus L Rev 119. See also Karmel, “The Relationship Between Mandatory Disclosure and Prohibitions against Insider Trading: Why A Property Rights Theory of Inside Information Is Untenable” (1993) 59 Brooklyn L Rev 149.

<sup>120</sup> See generally Avgouleas, *supra* note 2, at 80–85.

<sup>121</sup> See Easterbrook, “Insider dealing, Secret Agents, Evidentiary Privileges, and the Production of Information” [1981] Sup Ct Rev 309, at 335.

<sup>122</sup> 445 US 222, at 248 (1980).

<sup>123</sup> See Easterbrook, *supra* note 121, at 323 *et seq.*

we still have to justify the ethical standpoint that a particular writer takes on a particular situation.<sup>124</sup> A more straightforward argument would be that counterparties to such insider dealing transactions are the victims as they suffer directly from a lack of market sensitive information.<sup>125</sup>

In addition, one may further argue that insider dealing is wrong (or unfair) because other investors do not have equal access to inside information.<sup>126</sup> This “equal access theory” could work in combination with other theories (e.g. fair dealing or property theory).<sup>127</sup> The swing in public policy against insider dealing would greatly influence how we formulate and interpret the insider dealing rule, particularly in grey area cases like *Chiarella*.

From a more practical point of view, how legislators and judges in each jurisdiction approach insider dealing transactions and construe the law certainly depends on statutory language. The US law makes strong reference to “fraud” because the US insider dealing rule comes from the anti-fraud provision in the Securities Exchange Act of 1934.<sup>128</sup>

In contrast, there is no use of the term “defraud” in UK law; the FSMA 2000 puts insider dealing under the heading of “market abuse”, which gives clues on how to deal with “insider dealing”. The way the FSMA 2000 determines the legal consequences of such kinds of market abuse (i.e. not avoiding a contract but imposing penalties or ordering restitution as remedies) suggests that the FSA focuses on the market as a whole rather than an individual corporation or counterparty. In addition, structuring insider dealing under “market abuse” has

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<sup>124</sup> See Lawson, “The Ethics of Insider dealing” (1988) 11 Harv J L & Pub Pol’y 727; response by Macey, “Comment: Ethics, Economics, and Insider dealing: Ayn Rand Meets the Theory of the Firm” (1988) 11 Harv J L & Pub Pol’y 785.

<sup>125</sup> See Strudler & Orts, “Moral Principle in the Law of Insider dealing” (1999) 78 Tex L Rev 375.

<sup>126</sup> This rule was first adopted by a US court but later rejected. See *SEC v Texas Gulf Sulfur Co*, 401 F 2d 833 (1968).

<sup>127</sup> See Lee, *supra* note 119.

<sup>128</sup> See 15 USCA 78j.

the advantage of avoiding the need to force all arguments into the mould of “fraud”, as in the US.<sup>129</sup>

In the end, we should be aware that the insider dealing rule was developed in securities regulations to regulate the securities market. If we move beyond the securities market, we may find similar concerns about price, unfairness, and even fraud in relation to potential insider dealing. However, there also exist certain difficulties, as we are faced with the intersection of physical trading and notional trading and have to keep a balance between the common law non-disclosure rule and a more regulatory-style insider dealing rule. It is on this basis that we will continue our arguments.

## **5.5.2 Application to the Risk Trading Market**

### **5.5.2.1 Securities-related Exchange Trading**

The concerns arising from insider dealing in the securities market might also be applied in the futures, options or other securities-related products traded on exchanges. Insider dealing by way of securities-related derivative instruments is already regulated in both the UK and the US.<sup>130</sup> The case for securities-related options is simpler: an insider can make profits by arbitraging the fluctuation of the option prices or between the current securities prices and the future option exercise prices; he may also make profits or avoid immediate loss by using his inside information to buy or sell single-name securities futures contracts (e.g. futures contracts for British Petroleum stocks).

However, making profits on the futures market is not as simple as buying and selling stocks or bonds in a securities exchange. Until the futures product matures, a trader does not really pay for the underlying assets (but only the

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<sup>129</sup> See generally, Loke, “From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the UK, Australia and Singapore” (2006) 54 Am J Comp L 123.

<sup>130</sup> See Criminal Justice Act 1993, Schedule 2. In the US, the Securities Exchange Act has already included insider dealing by way of a securities-based swap agreement. See 15 USCA 78j. “Security future”, which generally means futures of a single stock, have been included in the definition of “security” under the Securities and Exchange Act of 1934 as well as the Securities Act of 1933 after the Commodity Futures Modernization Act of 2000.

margin). For example, if we borrow the facts from *SEC v Texas Gulf Sulfur Co*<sup>131</sup>, the TGF had some good news on discovering a new oil field. Before announcing this new discovery in a clear way, some directors traded the company's stocks on the market, and the directors were held to be responsible for insider dealing. If any one of these directors wanted to profit from futures trading using their inside information, he had to build up long futures positions and liquidate as soon as the information was published (assuming that the announcement of such information would have led to the rise of the TGF's stock price). Since technically he did not hold any valuable assets but only a contractual right to buy the underlying assets at the end of trading, we could hardly deem him to have made a profit unless the position is liquidated. This shows that a futures position is a contract that expires at a certain point of time in the future (by triggering the process of physical delivery or cash settlement). Moreover, we may also further compare the situation where the director does not buy company stocks but lands lying near the site of the new oil field. Should the directors disclose the information to the land owner (which would presumably increase the property prices)? In principle, the common law non-disclosure rule should apply (unless the court holds otherwise).<sup>132</sup>

In addition, more difficulties arise if an insider trades indices futures (such as the FTSE 100 futures). In order to establish that the insider used his inside knowledge to earn a profit in the index futures market, we have to establish the connections between the sensitive information and not only the price of the securities but also the movement of the futures market. Since an index might be influenced by many factors other than information concerning a single company, the causal link between a piece of information and the index might become problematic.

We should then consider why insider dealing by securities-related futures should be regulated as under current law. If the misappropriation theory is the basis, it probably does not matter much whether an insider trades in the spot market or in

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<sup>131</sup> 401 F 2d 833 (1968).

<sup>132</sup> See Fried, *supra* note 29, Chapter 6.

the securities-related futures market. After all, the insider is penalised because he misappropriates corporate information to gain his own profits for himself. Moral theories might also help to support this point. However, difficulties remain in determining the amount of damages or restitution to be attributed if an insider trades market index futures before a piece of material information is disclosed.

On the other hand, if using inside information in the securities-related futures market is not desirable because it could be seen as a type of market abuse or is a fraud on the market, further research is needed to establish the link between information and the prices of a specific futures product in order to explain the potential negative impact on the market. After all, since the futures prices reflect expectations for the future, more has to be done to establish the future “price integrity” than in the spot securities market.

## **5.5.2.2 Commodity Transactions**

### **5.5.2.2.1 Some Problems**

If we expand our framework beyond securities, it will be seen that scenarios similar to securities insider dealing may still occur in the commodities market. Something akin to the Bin Laden example we gave earlier could well occur in a big oil company, to the directors of such a company or any person receiving trading tips from these “insiders”. Information in the commodities market is as important as in the securities market.

There are several situations where commodity insider dealing could occur. First, an insider could arbitrage price differences in the spot market, in the futures market, or between spot and futures market prices. By comparison with the securities market, it is more difficult to make a fortune by arbitraging in the spot commodity market. Higher liquidity in the market is the key to making such a scheme viable. It is obviously easier to conduct commodities insider dealing on organised exchanges where a person can buy, sell, and liquidate transactions quickly and at lower costs. However, with the help of standardised documentation in commodities trading, and to some extent the use of clearing

clauses (such as circle clauses), a trader may still earn price differences by way of spot market commodity trades (see 3.3.2 above). In addition, if, using inside information, a person buys a commodity (e.g. gold) and keeps it as long-term investment rather than arbitraging price differences within a short period of time, it is arguable whether this is a kind of insider dealing that merits punishment.

Secondly, insider dealing may occur if an insider uses inside information regarding the production of a commodity to make a profit.<sup>133</sup> For example, a leading agricultural company knows that the production of August crops will not be good this year. Before this production information is disclosed to the market, either the company itself or one of its directors uses this information to sell agriculture futures. In the securities market, the same scenario would constitute insider dealing.<sup>134</sup> Likewise, big universal banks may acquire significant inside knowledge about the various aspects of their banking business and use the information for speculative trading.<sup>135</sup>

Thirdly, one could use inside information for personal profit by taking a step ahead of a market participant's transactions—this is sometimes called the problem of “front-running”.<sup>136</sup> Tips could range from the market participant's hedging strategies to a bulky spot (or futures) transaction and could influence market prices in a significant fashion. For example, knowing that part of the Shell strategy is to sell Brent futures positions in bulk, an insider might sell Brent

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<sup>133</sup> Dan Morgan relates several stories about how a few dominant grain companies search production news from all around the world in order to grab a business opportunity. Grain merchants' operations in the futures also raise certain concerns. See Morgan, *Merchants of Grain*, at 429 *et seq.* (Penguin, 1980).

<sup>134</sup> Cf. *SEC v Texas Gulf Sulfur Co*, 401 F 2d 833 (1968).

<sup>135</sup> There situation entails a “Chinese Wall” issue. See “Frontier Justice” *The Economist* (21-27 October 2006).

<sup>136</sup> Markham distinguishes three types of front-running in the commodity futures market: “(1) trading by third parties who are tipped on an impending block trade (“tippee” trading); (2) transactions in which the owner or purchaser of the block trade itself engages in the offsetting futures or options transaction as a means of “hedging” against price fluctuations caused by the block transaction (“self-front-running”); and (3) transactions where a broker with knowledge of an impending customer block order trades ahead of that order for the broker's own profit (“trading ahead”). Markham, “‘Front-running’—Insider Dealing under the Commodity Exchange Act” (1988) 38 *Cath U L Rev* 69, at 71. The FSA Handbook defines front running/pre-positioning as “a transaction for a person's own benefit, on the basis of and ahead of an order which he is to carry out with or for another (in respect of which information concerning the order is inside information), which takes advantage of the anticipated impact of the order on the market price”. FSA Handbook MAR 1.3.3(2).

futures before Shell does and buy back positions after Shell has sold its futures (assuming that Shell's bulk trading would send futures prices down in the short term and no other factors were involved).

Fourthly, a more serious problem would occur if one tried to make a profit by creating a significant market event, which is not a remote possibility in a globalised society, given that the market prices for some major commodities (such as crude oil and currencies) are greatly influenced not only by the law of supply and demand but also by major economic and political events. A powerful trader might also corner the market to fuel up spot or futures prices so that he could make profit on his own speculative positions.<sup>137</sup> This does indeed enter the realm of market manipulation or market abuse rather than traders merely using their information to their own advantage.

Fifthly, insider dealing may well occur across different sectors, not just in a single market. Some big market participants might have interests in different products or industries, such that they are in a powerful position to use information acquired in one market for trading in another market.<sup>138</sup> For example, a particularly bad crop year in the US would affect not only domestic buyers and sellers but also foreign spot or futures markets, as merchants might seek supplies from somewhere outside the US. Prices of substitute raw materials could also rise if other traders turned to other alternatives.

In addition, two markets can be inter-connected even though, superficially, they appear to be unrelated. For example, the corn futures market has become a playground for many energy traders because corn is increasingly being used to manufacture ethanol.<sup>139</sup> The energy industry might feel the heat if corn prices were driven too high, and prices for ethanol would be affected. A bad crop year might also send shockwaves through the freight market, as shipping from the US

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<sup>137</sup> For example, British Petroleum was subject to investigation for manipulative trading practices in the US. See Grant, "BP's Aggressive Trading Culture Comes to Surface" *Financial Times* (3 July 2006). See also Morgan, *supra* 133.

<sup>138</sup> For example, Morgan has a lively illustration of the cross-industry operation of Cargill, one of the biggest grain trading companies in the world. See Morgan, *supra* 133, at 230.

<sup>139</sup> See Morrisonin, "Corn Futures Trading Volumes Reach Record" *Financial Times* (19 June 2006).

might diminish in the future and thus also affect freight rate forwards/swaps.<sup>140</sup> In addition, a bad crop year would certainly influence the share prices of big agricultural companies (as well as the industry in general). This would again lead to the realm of insider dealing in securities.

#### 5.5.2.2.2 Discussion

We may analyse potential insider dealing issues in the commodities market in two dimensions: who uses the inside information and what are the purposes of using such inside information.

First, from the above scenarios, we might find that potential insider dealing in the commodities market is not limited to corporate insiders or tippees who know something about the company that is not yet known to outsiders. There is a chance that it is the company itself using inside information rather than a corporate insider using the company's information. This reflects the differences between the commodities market and the securities market. Normally, an issuer of securities would not buy and sell its own stocks or bonds circulated in the secondary market and, even if it did buy back its stocks, there are certain rules in company law or securities regulation that the issuing company has to follow.<sup>141</sup> Buying back its own shares might also raise market manipulation concerns and allow regulators to intervene.<sup>142</sup> Thus, in the securities market, usually we focus on insider dealing of corporate directors or other insiders.

In contrast, in the commodities market, it is open to manufacturers, producers and any corporate or non-corporate insider to trade at the same time. Both the source of information and the insiders who have access to the information could conduct

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<sup>140</sup> The maritime freight rate is subject to fluctuation much like commodities. Thus, there has evolved a forward freight rate swap to allow shippers to hedge against freight rate risk. Examples can be seen in *Dampskibsselskabet "Norden" A/S v Andre & CIE SA* [2003] 1 Lloyd's Rep 287; *Erne Shipping Inc v HBC Hamburg Bulk Carriers GmbH*, 409 F Supp 2d 427 (2006). It was once reported that a New York agent, who made a mistake while bidding on corn for his client, asked his client to delay reporting the sale or booking ships for a few hours so that he could manage to recover the losses he made (by his own mistake) in the futures market. This story shows that how the shipping industry is closely linked with international grain sales. See Morgan, *supra* 133, at 284–285.

<sup>141</sup> See Companies Act 2006, section 658 *et seq.*

<sup>142</sup> See generally, Avgouleas, *supra* note 2, at 280 *et seq.*



trading with this inside information. Where a director or any other inside personnel uses his inside knowledge to make personal profits, this is similar to insider dealing in securities; thus, we may attempt to apply the same line of analysis developed in securities regulation. However, where it is the generator of information that enters into trading using his own inside knowledge, there are more conflicts between the common law non-disclosure rule and the idea of prohibiting insider dealing in the financial market as a whole.

Secondly, the reasons for an insider dealing transaction might enter into the question. In the context of risk trading contracts, one person could make an insider dealing transaction for the purpose of hedging future losses as well as speculating on the market. If speculation is the sole purpose, this is more comparable to insider dealing in the securities market since it is closer to opportunistic behaviour that can be attacked on moral grounds. In contrast, since hedging is more or less established as a legitimate purpose (see 4.3 above), it is arguable that there is nothing wrong with using unpublished material information to avoid one's own loss, especially when it is the company, rather than a director or any other corporate insider, who uses the inside information in trading.

We should also note that there is already a continuous duty of disclosure of material information to the market in securities regulation (see 5.2 above). Thus, it is natural to prohibit insiders from exploiting that information before it is published. In contrast, as regulation on commodities trading does not contain such a duty, why should we bother to ask people not to use his inside information if, in principle, they are allowed to take any information advantage? A balance must be made between the common law rule and the insider dealing rule imposed by statutes. The reasons why we perceive insider dealing as wrong will determine how important we find tackling insider dealing in the non-securities market.

As in the securities market, there are two lines of analysis we may follow. On the one hand, we could follow the line of price integrity. However, we should be cautious when comparing futures prices with spot market prices as there is no

doubt that a piece of information could influence both the physical market and the hedging market (*Laidlaw v Organ*<sup>143</sup> is a good example). However, a non-disclosure of inside information does not automatically mean that market prices are wrong.<sup>144</sup> A coherent line of analysis has to be made to fully justify a wrongful price theory in relation to commodity insider dealing.<sup>145</sup>

On the other hand, if insider dealing is not wrong because of its market implications but because the insider uses a piece of information that does not belong to him, we should consider whether the problem could be resolved in other ways. In a more typical insider situation, the source of the information might use existing legal tools, such as fiduciary duties or confidentiality duties, to restrain directors, officers, employees or any contracted persons from using that information. Why should we launch a regulatory scheme to address the problem of corporate insiders using corporate information in the commodities market if the problem could be solved by inserting a contractual term to allow the company to sue for damages?

Currently, the FSA takes a fine line in distinguishing insider dealing as market abuse and trading with legitimate business.<sup>146</sup> The FSA has provided some guidelines on whether, in using inside information, a person is pursuing legitimate business. To quote in full:

In the opinion of the FSA, the following factors are to be taken into account in determining whether or not a person's behaviour is in pursuit of legitimate business, and are indications that it is:

- (1) the extent to which the relevant trading by the person is carried out in order to hedge a risk, and in particular the extent to which it neutralises and responds to a risk arising out of the person's legitimate business; or
- (2) whether, in the case of a transaction on the basis of inside information about a client's transaction which has been executed, the reason for it being inside information is that information about the transaction is not, or is not yet, required to be published under any relevant regulatory or exchange obligations; or
- (3) whether, if the relevant trading by that person is connected with a transaction entered into or to be entered into with a client (including a

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<sup>143</sup> 15 US 178 (1817).

<sup>144</sup> See also *Perdue*, *supra* note 40, at 366 *et seq.*

<sup>145</sup> See generally, *Avgouleas*, *supra* note 2, at 108–111.

<sup>146</sup> FSA Handbook, MAR 1.3.7.

potential client), the trading either has no impact on the price or there has been adequate disclosure to that client that trading will take place and he has not objected to it; or

(4) the extent to which the person's behaviour was reasonable by the proper standards of conduct of the market concerned, taking into account any relevant regulatory or legal obligations and whether the transaction is executed in a way which takes into account the need for the market as a whole to operate fairly and efficiently.<sup>147</sup>

This explanation appears to show that the FSA is trying to reconcile the common law and the market abuse rule in order to define the line between lawful business practice and market abuse conduct. The FSA is ready to allow a true hedging contract to stand even if inside information was used to make the hedging transaction. Insider dealing in the commodities market might be allowed if it is in line with the standards of market conduct (and thus no market “abuse”) or has no impact on the market (and thus no abuse of the “market”). Apparently, the more organised the market, the more likely that the financial regulator will enforce the relevant market abuse rules. However, it remains to be seen how far the FSA would extend the use of the insider dealing rule to risk trading contracts that take place outside the banking circle or organised exchanges. If such contracts are not touched by regulation, they will be governed by the common law rule, where one party might in principle enjoy his information advantage.

If a person intentionally stages an event to work market prices to his favour, this is probably more like market manipulation behaviour. To address this kind of conduct, a more comprehensive and focused market manipulation regulation might be better suited than a general prohibition on insider dealing. After all, market manipulation looks much more like straight fraud than mere non-disclosure.

Moreover, there might be concerns over the integrity and openness of trading if major participants worked the exchange and rules to their favour. Through such participants’ superior knowledge of the market, one might wonder whether

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<sup>147</sup> FSA Handbook, MAR 1.3.10.

“outsiders” were being treated fairly in the open market.<sup>148</sup> In this case, major market participants’ use of their inside knowledge might be subject to further scrutiny.<sup>149</sup> And one might further challenge the role an exchange could play in dealing with market manipulation or insider dealing.<sup>150</sup> In the off-exchange market, a further point might be the regulatory control (if any) of trade associations or non-profit organisations, which produce standard forms for the market.<sup>151</sup>

Lastly, certain insider dealing problems could be related to relationships among parties. For example, a front-running problem might occur where a broker trades for his own benefit before he trades for a client’s trading order.<sup>152</sup> If we turn to the private law side of the issue, front-running in the context of the broker-client relationship might raise the issue of breaching fiduciary duty (provided that a fiduciary relationship is established in the first place).

On the one hand, one argument to support a breach of fiduciary duty claim is based on the fact that a broker has to use information about his client’s order to make front-running transactions. Thus, it is arguable that a broker breaches his duty of confidentiality by front-running. In *Brandeis Brokers Ltd v Black*<sup>153</sup>, Brandeis, the broker, was accused of breaching his fiduciary duty to Black, his client, by mis-pricing and front-running. The arbitral tribunal held that it is a “misuse of confidential information” if a “broker discloses to outside parties, or uses for its own purposes, confidential information in its possession about a client’s positions, transactions or intended transactions” and that

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<sup>148</sup> Once it has been described that the futures market had a “club-like atmosphere”. Markham, *The History of Commodity Futures Trading and Its Regulation*, at 58 (Praeger, 1986). If this is the case, there could be suspicion of lapse of self-regulation by exchanges that might further enhance regulatory intervention.

<sup>149</sup> See FSA Handbook, MAR 1.3, particularly the example given in MAR 1.3.21.

<sup>150</sup> See Avgouleas, *supra* note 2, at 229–234 (OUP, 2005)

<sup>151</sup> See Bradley, “Private International Law-making for the Financial Markets” (2005) 29 *Fordham Int’l LJ* 127; Davis, “Production of Boilerplate: The Role of Nonprofits in the Production of Boilerplate” (2006) 104 *Mich L Rev* 1075.

<sup>152</sup> This kind of practice is already prohibited by the Financial Services Authority. FSA Handbook, MAR 1.3.2(2) and the example given in MAR 1.3.22. See also Blair & Walker (ed.), *Financial Services Law*, at 6.58 (OUP, 2006).

<sup>153</sup> [2001] 2 *Lloyd’s Rep* 359.

“[f]ront-running would be a particular form of misuse of confidential information”.<sup>154</sup> Toulson J upheld the arbitral decision.

On the other hand, another argument is that a broker’s front-running moves market prices before his client’s order and thus puts his client in a less favourable place if a broker trades ahead of a bulky order. In an American case, *Dial*, the defendant, was accused of committing mail fraud in violation of a federal statute by trading ahead of a client’s trading order in the Chicago Board of Trade.<sup>155</sup> The main issue was fraud rather than fiduciary duties. However, the Seventh Circuit Court also held that

“Dial, when he solicited his customers to participate in block orders, implicitly represented to them that he would try to get the best possible price. He could have gotten a better price by putting their orders in ahead of the orders he placed for his own accounts and those of his friends. In trading ahead of his customers without telling them what he was doing, he was misleading them for his own profit, and conduct of this type has long been considered fraudulent.”<sup>156</sup>

In the end, *Dial* was held to have committed fraud. If we follow the above two judgments, it seems that it is accepted by both the UK and US court that a commodity futures broker breaches his duty of confidentiality or loyalty by front-running a client’s order. We may also find that misappropriation or fiduciary theory might become the basis for regulation against front-running by a commodity futures broker.

### 5.5.2.3 Credit Market

We now turn to potential insider dealing and OTC transactions, starting first with the credit market. To take an example, a person learns from the director of a big company that the company might suffer a major credit default. Subsequently, that person (as a risk seller) chooses to enter into a CDS with a bank to insure against the credit risks of that company. Soon after, the default does occur and the person may earn some monies even without owning the bonds of the

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<sup>154</sup> *Id.*, at 366.

<sup>155</sup> *US v Dial*, 757 F 2d 163 (1985).

<sup>156</sup> *Id.*, at 168.

company (subject to the terms of the CDS). Even for a true hedger, such a manoeuvre could still earn him a lower fixed-rate for the CDS since the CDS rate would rise to reflect the new credit exposure after a default. Inside information could influence the credit market in the same way that arbitraging securities prices does.

Apart from the theories mentioned above, we could put forward two more arguments on the issue of potential insider dealing in the credit derivative market. On the one hand, perhaps what we dislike most is people behaving opportunistically in arbitraging information advantages. When one speculates on the credit market, one is actually trying to make a fortune from the misery of an issuer or a creditor. This kind of opportunistic conduct might easily invite negative remarks.

On the other hand, to use an argument similar to those used in insurance, if a person takes advantage of his prior knowledge of certain credit issues of a third party and buys protection with a lower rate from a risk buyer, one could argue that he is not acting in good faith.<sup>157</sup> Without additional help from regulators, we can only rely on the contract or common law doctrines such as fraud, misrepresentation or mistake. A duty of utmost good faith followed by a duty of disclosure might solve the problem; however, we have found no convincing reason to impose a duty of “utmost good faith” in our above analysis (see 5.3.3 above). The market abuse approach taken by the FSMA 2000 might be a more flexible way of dealing with this issue than the fraud theories developed in both securities regulation and commodities regulation in the US. Again, these issues might also be resolved through contractual terms; thus, arguably there is no need for the law to intervene as a party can protect himself by negotiating better contractual terms. In this circumstance, issues relating to bargaining power and the party’s ability to negotiate terms to protect himself would come to the fore.

Lastly, the credit market could be closely connected with the securities market. For a CDS, this partly depends on how wide a credit event is defined in each

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<sup>157</sup> See also Schwartz, “Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation” (2007) 12 *Fordham J Corp & Fin L* 167, at 191–192.

credit derivative instrument. For a credit total return swap<sup>158</sup>, all the gains (including price appreciation) from the reference obligation (e.g. a corporate bond) are transferred from a risk seller to the risk buyer. If either party has inside knowledge about something that is bound to happen, they could actually make a profit through a total return swap, much like arbitraging in the securities market. The same might be argued for an equity swap (see 2.2.2.3 above). It is not easy to estimate the probability of success regarding such manoeuvres in practice. Unless the credit event happens very rapidly and the first settlement date is not far off, it might not be easy for such a scheme to succeed. But however likely it may be, we could still recognise that an insider has a chance to use the growing credit market to earn private profit. He is still using corporate information, but he is not necessarily creating wrongful market prices (with regard to those securities). This might provide further challenges to financial regulators when the credit market booms.<sup>159</sup>

#### 5.5.2.4 Other OTC Transactions

In the end, we should consider the potential insider dealing problems raised by other cash-settled OTC derivative transactions. Given the variety of instruments and traders, it would be nearly impossible to exhaust the possibilities for using OTC instruments for purposes of insider dealing. For instance, it is not unthinkable that the major shareholder of a company might use its insider knowledge of the company's operations to enter into an equity swap (see 2.2.2.3 above). A company might also make a profit from having contracts for differences or equity swap before announcing a plan to take over another company whose shares underlie the contract for differences or swap.<sup>160</sup>

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<sup>158</sup> Under a total return swap, one party (A) pays periodically to the other party (B) bond interests and any appreciation of bond prices, and B pays to A interests based on a market floating rate and any depreciation of the bond prices. *See* Das, *Credit Derivatives: CDOs & Structured Credit Products* (3rd ed., John Wiley & Sons, 2005).

<sup>159</sup> *See* Bowles & Fox, "Credit Markets and Market Abuse" (2007) 22(4) JIBFL 209.

<sup>160</sup> In 1995, Trafalgar House plc had a series of equity swaps (structured as contracts for differences) on certain regional electricity companies before announcing a takeover for one of the electricity companies. Trafalgar House plc was accused of insider dealing, but was cleared by the Takeover Panel. *See* Das, *Structured Products Volume 2: Equity; Commodity; Credit & New Markets*, at 422–423 (3rd ed. rev edn, John Wiley & Sons, 2006).

There could be several motives for using inside information in OTC transactions. On the one hand, an insider might wish to take advantage of his information and make a deal at a lower price—such a situation is similar to *Laidlaw v Organ*<sup>161</sup> except that the information advantage is applied in a different type of trading. Whether an insider dealing transaction based on this motive is worth punishment as an abuse of market requires further clarification by judges and regulators.

On the other hand, a person might use his information advantage to make a straight profit. The current FSA insider dealing rules broadly cover “dealing” in qualified investment related investment on the basis of inside information. In one of the examples given by the FSA, the FSA would regard a director’s spread bet on securities prices of a company as insider dealing if the director placed his bet on the basis of the belief that undisclosed news about the company’s imminent takeover would increase the value of his shares.<sup>162</sup> If we follow this example, entering into a contract for differences (e.g. interest rate swap, spread bets etc.) on the basis of inside information might fall under the UK market abuse rule.

Again, we could see the contrast between the application of the common law non-disclosure rule and the market abuse/insider dealing rule in the context of OTC trading. The common law rule is restrained by the scope of insider dealing regulation. In other words, trading OTC derivative instruments with inside information might not be wrong except when it is recognised as an instance of market abuse.

#### 5.5.2.5 Summary

In this part, we have noted that insider dealing problems might arise in the risk trading market. The insider dealing rule has largely been developed in the securities market, so where securities are involved, there should not be a problem in applying the securities insider dealing rule. In contrast, what concerns us here is insider dealing in non-securities related markets. To this end, we have found

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<sup>161</sup> 15 US 178 (1817).

<sup>162</sup> See FSA Handbook, MAR 1.3.20(1) (examples of market abuse).



that commodities futures prices are not directly comparable with spot market prices, and thus price integrity arguments might be a persuasive way of extending the securities insider dealing rule to the commodities market. On the other hand, we face the difficulty of reconciling the common law non-disclosure rule and the idea of insider dealing. This is a policy decision, and Parliament or financial regulators should have the final say on how far a trader may enjoy advantages deriving from inside information. In addition, we also identified a source of potential problems in the credit market and noted that there might be some moral arguments against people speculating on other people's credit. Lastly, where a person intentionally creates an event to work market prices to his favour, this is not merely insider dealing but a deceptive or manipulative scheme. Such kinds of behaviour might be called "fraud" and should be taken in hand by regulators, if not by courts through other common law options.

## 5.6 Conclusion

In this chapter, we have explored issues of pre-contractual disclosure for the risk trading contracts we introduced in Chapters 2 to 4. Risk trading contracts strongly rely on all sorts of information as they deal with future uncertainties. Indeed, for every transaction there is a certain degree of asymmetric information. The problem is how the law tips the balance in different contexts. Our approach is to see whether risk trading contracts could fit into existing categories that require disclosure rather than creating a general duty of disclosure.

In common law, there is no general duty of disclosure before a contract is made. So a contractual party could take advantage of any information of which the counterparty is ignorant. However, this general rule is restricted by the law of deceit and misrepresentation: where any non-disclosure can constitute fraud or misrepresentation, the information holder has to disclose to avoid further liability.

There also exist several exceptions to the general rule, and it is on these exceptions that we can draw a comparison with risk trading contracts. First, we

have seen that mandatory disclosure in the securities market cannot be extended to exchange-traded futures contracts (save where securities are involved) because of the nature of securities. With regard to commodity futures, it is impractical to impose similar duties on those who produce the underlying commodities (*cf.* issuers of stocks).

Secondly, there is also a duty of disclosure structured under a wider duty of utmost good faith for insurance contracts. However, we find this is less successful in risk trading contracts. On the one hand, it lacks a uniform definition of hedging, speculative or derivative instruments, such that any general duty could have a wider and more profound impact than intended. On the other hand, non-insurance risk trading contracts lack the inequality of knowledge issue underlying contracts of insurance. While the duty of good faith could play a role in filling the gap between fraud and the common law non-disclosure rule in insurance, we cannot draw the same comparison for most risk trading contracts. This is not to say that there could be no moral hazard issues in the derivative market. However, since the current market is still limited to transactions between sophisticated market participants, it is less an issue because parties can address the problem in their contracts. Further problems may evolve in the future, should modern hedging or speculative contracts become more consumerised.

Thirdly, we have found that the prohibition of insider dealing has some impact on the issue of pre-contractual disclosure. The insider dealing rule does not really require traders to disclose information but prohibits them from using it. The insider dealing rule has already been the subject of various discussions and the underpinning theories of why insider dealing is wrong can determine how far we should go to deal with this problem. On the one hand, we have to be careful when drawing comparison between futures and spot prices. It is also hard to provide a comprehensive theory to distinguish the general rule of non-disclosure (as in *Laidlaw v Organ*) from the insider dealing rule in securities regulation. On the other hand, we could also argue from a moral perspective against speculating on another person's information. The overarching concepts of

“market abuse” or “market fraud” might provide a better basis for addressing information issues in the risk trading market. Nevertheless, there remains much to research before reaching a more complete conclusion.

Ultimately, our question is: where does one draw the line between a more lenient common law approach and additional regulatory disclosure rules regarding information problems in risk trading contracts? This might be a question Parliament and regulators have to consider in the future.

## **Chapter 6 Conclusion**

### **6.1 A Review of the Contractual Nature of Derivative Instruments**

In this thesis, we examine the contractual nature of derivative instruments—contracts that allow parties to buy and sell risks. Derivatives trading could be traced back to commodity sales, but it also resembles gambling and insurance in certain aspects. The use of derivatives in the financial markets adds a major regulatory dimension to the market. Indeed, modern risk trading contracts inhabit the grey area of several legal fields, which leads to a certain degree of legal risk. The wide variety of derivative instruments gives us several angles from which to conduct an analysis. What we are interested in, in this thesis, is to explore the contractual nature of risk trading contracts in order to see whether certain established legal doctrines could, or should, be applied or extended to risk trading contracts, and whether certain problems should invite further regulatory intervention.

In Chapter 2, we illustrated various sources of risk that market participants try to avoid and generally defined “risk” as future uncertainties that might cause monetary losses. Over time, several legal instruments (such as insurance and guarantees) have been created to combat risks. Derivative instruments have arisen not only to provide powerful tools with which to manage risks, but also to help to commoditise the abstract concept of “risk” into something more tangible that people can buy and sell. However, risk trading can take various forms. Risk trading may consist of buying and selling contradictory contracts at different times (e.g. commodity futures—see 3.2 above) or by settling a contract in cash by

price differences (e.g. an interest rate swap—see 2.2.2.3). It could also take the form of payment after the occurrence of an event (e.g. a credit default swap—see 2.2.2.3) or be structured as a capital market instrument whose payoff depends on the occurrence or non-occurrence of a future event (e.g. a catastrophe bond—see 2.2.2.4). Thus, derivative instruments are also exposed to the risk of being recharacterised as existing legal instruments (such as sale of goods, insurance, gambling and securities), which might contribute to certain legal uncertainties. This lays the foundation of our analysis.

With regard to securities (such as shares of a company), this thesis recognises that non-securitised derivative instruments lack the character of securities, so they should not fall under regulations governing typical securities, including the rule to disclose certain information (see 5.2). On the other hand, securitised instruments come close to traditional capital market instruments and open the door to be regulated like other securities (see 2.4 and 5.2). However, we also found that the insider dealing rule might have a more extensive application to transactions that involve not only securities-related derivative instruments but also commodity or credit derivative transactions (see 5.5).

With regard to insurance, a close interpretation of the definition of “insurance” might exclude several derivative instruments from the scope of insurance law. However, certain products (particularly credit derivatives) look quite similar to insurance, which raises the question whether derivatives, which might serve a similar function to insurance policies, should be treated in law like insurance. This thesis aims to raise awareness of the fact that it is necessary to consider the rationale behind insurance regulation and insurance contract law, rather than to accept these special rules in insurance law as God-given. With this view, the relationship between insurance and OTC derivative instruments could be approached from several angles.

First, we suggested that both property insurance (as contracts of indemnity) and life policies (as contracts of contingency) should both be taken into account. It is too limiting to restrict current derivative markets to transactions only serving the purpose of indemnifying hedgers’ real losses. However, this does not

change the fact that derivative instruments, if used for hedging, might be used as a compensatory tool (see 2.5 and 4.4.2).

Secondly, if being regulated like insurance companies is the major concern, we have to consider the reasons why insurance companies are regulated and to what extent a firm specialising in instruments serving a similar function to insurance should be regulated as an insurance company. Thus, we should first consider whether a seller of derivative instruments should be regulated in the first place, and if the answer is yes, the next question is how to regulate them. This argument leads to the conclusion that banks or financial institutions that are already regulated need not to be regulated as insurance companies. Whether non-bank and non-insurance firms should be regulated as insurance companies is another matter that could be pursued further (see 2.5 above).

Thirdly, we find no reason to see derivative instruments as another type of contract *uberrimae fidei*, even though there might be potential asymmetric information and moral hazard problems underlying insurance law. In contrast, we argue that the information issue might better be resolved in the contract (if parties think it is important) or by market manipulation regulation, rather than avoiding contracts on the grounds that a duty of utmost good faith has not been honoured.

With regard to “futures” regulation, we find that commodity contracts with delivery obligation may not be any different from sale of goods contracts. The impact of the private law aspect of the sale of goods law is relatively minor, but the potential regulatory impact cannot be ignored. To distinguish regulated “futures” contracts for “investment” purposes from commercial sale of goods contracts, we propose a theory based on a physical/notional distinction. Thus, exchange-traded contracts are regulated “futures” because the whole exchange trading scheme has become largely notional, such that traders can buy and sell contradictory contracts and settle in cash. In contrast, off-exchange trading schemes which ultimately are settled in cash are notional transactions and should be regulated as “futures” under current UK and US law. In contrast, if most of the transactions in a trading scheme contain transactions ending in delivery, they

are geared for physical trading and should not be regulated as investment (see 3.3.4).

With regard to gambling and cash-settled contracts without delivery obligations, we argue that notional derivative transactions are aleatory in nature (like traditional gambling instruments). Both speculative notional transactions and gambling are instruments intended to be used for making a profit from future uncertainties (see 4.4.1). Gambling and speculation might also share similar problems (see 4.3). Thus, the question is how to deal with gambling or speculation in the market. A variety of legal consequences and policy concerns exist around the world; therefore, we attempted to provide an analytical structure that might host different considerations. First, if two parties are already regulated persons (e.g. banks), we argue that the intervention of gambling laws is unnecessary, as it is enough to use financial regulation to control potential problems from excessive speculation. Secondly, it depends on the policy of a jurisdiction to decide whether gambling or speculation between two individuals or between two companies should be allowed. Thirdly, if a speculative transaction occurs between a specialised firm and a customer, it is up to local policy to decide whether it is best to regulate the firm through financial regulation or under gambling regulation (see 4.4.3). A consistent line of analysis should be established to demarcate the respective jurisdictions of financial regulator and gambling regulator.

## **6.2 A Derivative Contract Law?**

Let us briefly summarise the question whether modern risk trading contracts should be treated as a new class of contracts in the private law sphere. The above discussion found that derivative instruments might not fit well into any existing category. Some derivative instruments are simply contracts of sale for future delivery, but most conclude with cash settlement. Derivatives might be similar to insurance, but are currently not limited by the nature of indemnity, in contrast to property insurance. Speculation by way of derivatives trading might not differ from gambling, but derivatives may well be employed for hedging or

other commercial purposes. Gambling, as a special group of contracts long seen in a negative light, has lost its distinctive character since the Gambling Act 2005. In addition, risk trading itself does not automatically imply the application of fiduciary duty or a duty of care in tort law.

The fact that risk trading instruments appear not to fit into any existing category suggests that having a separate set of “derivative contracts” might be one way of solving potential problems (e.g. information asymmetry, suitability, over-speculation etc.). Nevertheless, if such a special branch were to exist, there would be no substance in a “derivatives contract law” until legislators or judges were willing to create new private law rules or extend current ones to encompass derivative instruments.

However, this does not mean that private law cannot play a role in the development of the risk trading market. Like many other contracts, risk trading contracts remain deeply rooted in general contract law. They might further be analysed in the context of arm’s length and consumer transactions—in short, analysing “who uses risk trading instruments” and “what relationships hold between parties”. Doctrines such as fraud, misrepresentation, fiduciary duty, duty of care in tort law, frustration etc. would still shape the basic contractual relationship between any two parties. Information problems might be resolved further down the line through consumer/investor protection or “cheating” in gambling laws. Rights and obligations under a continuous master agreement or brokerage agreement scheme might further provide us with several more ways of examining derivatives trading. Thus, we can build on existing common law concepts to solve potential problems. Even without regulatory intervention, there is still much room to develop private law concepts to deal with the trading of risks.

In the end, if treating derivative instruments as an independent category cannot solve every problem, does this mean that it might be better to tackle each subcategory of risk trading instrument separately? We have already seen that futures exchanges and clearing houses are subject to financial regulation. Nevertheless, it is still unclear how far off-exchange trading contracts will evolve



in both the private law system and relevant public regulation. As the market grows, certain products (like interest rate swaps or credit default swaps) might attract much more attention than other products. However, we have to bear in mind that any further categorisation of the risk trading market might enhance legal uncertainties and increase the risk of recharacterisation. This thesis does not make the bold claim that such further sub-categorisation is destined, but we should be aware of further legal development under the umbrella of “derivatives”, as we have seen in the cases of insurance and securities.

# Appendix 1 Selected UK Statutes

## **Criminal Justice Act 1993**

### **Section 52**

- (1) An individual who has information as an insider is guilty of insider dealing if, in the circumstances mentioned in subsection (3), he deals in securities that are price-affected securities in relation to the information.
- (2) An individual who has information as an insider is also guilty of insider dealing if—
  - (a) he encourages another person to deal in securities that are (whether or not that other knows it) price-affected securities in relation to the information, knowing or having reasonable cause to believe that the dealing would take place in the circumstances mentioned in subsection (3); or
  - (b) he discloses the information, otherwise than in the proper performance of the functions of his employment, office or profession, to another person.
- (3) The circumstances referred to above are that the acquisition or disposal in question occurs on a regulated market, or that the person dealing relies on a professional intermediary or is himself acting as a professional intermediary.
- (4) This section has effect subject to section 53.

## **Financial Services and Markets Act 2000**

### **Section 19**

- (1) No person may carry on a regulated activity in the United Kingdom, or purport to do so, unless he is—
  - (a) an authorised person; or
  - (b) an exempt person.
- (2) The prohibition is referred to in this Act as the general prohibition.

### **Section 26**

- (1) An agreement made by a person in the course of carrying on a regulated activity in contravention of the general prohibition is unenforceable against the other party.
- (2) The other party is entitled to recover—
  - (a) any money or other property paid or transferred by him under the agreement; and
  - (b) compensation for any loss sustained by him as a result of having parted with it.

- (3) "Agreement" means an agreement-
  - (a) made after this section comes into force; and
  - (b) the making or performance of which constitutes, or is part of, the regulated activity in question.
- (4) This section does not apply if the regulated activity is accepting deposits.

### **Section 150**

- (1) A contravention by an authorised person of a rule is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.
- (2) If rules so provide, subsection (1) does not apply to contravention of a specified provision of those rules.
- (3) In prescribed cases, a contravention of a rule which would be actionable at the suit of a private person is actionable at the suit of a person who is not a private person, subject to the defences and other incidents applying to actions for breach of statutory duty.
- (4) In subsections (1) and (3) "rule" does not include-
  - (a) listing rules; or
  - (b) a rule requiring an authorised person to have or maintain financial resources.
- (5) "Private person" has such meaning as may be prescribed.

### **Section 151**

- (1) A person is not guilty of an offence by reason of a contravention of a rule made by the Authority.
- (2) No such contravention makes any transaction void or unenforceable.

### **Schedule 2**

#### *Options*

17. Options to acquire or dispose of property.

#### *Futures*

18. Rights under a contract for the sale of a commodity or property of any other description under which delivery is to be made at a future date.

#### *Contracts for Differences*

19. Rights under-

- (a) a contract for differences; or
- (b) any other contract the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in-
  - (i) the value or price of property of any description; or
  - (ii) an index or other factor designated for that purpose in the contract.

20. Rights under a contract of insurance, including rights under contracts falling within head C of Schedule 2 to the Friendly Societies Act 1992.

## **Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2001/544**

### **Risk Management**

19 (1) A person (“B”) does not carry on an activity of the kind specified by article 14 by entering as principal into a transaction with another person (“C”) if—

- (a) the transaction relates to investments of the kind specified by any of articles 83 to 85 (or article 89 so far as relevant to any of those articles);
  - (b) neither B nor C is an individual;
  - (c) the sole or main purpose for which B enters into the transaction (either by itself or in combination with other such transactions) is that of limiting the extent to which a relevant business will be affected by any identifiable risk arising otherwise than as a result of the carrying on of a regulated activity; and
  - (d) the relevant business consists mainly of activities other than—
    - (i) regulated activities; or
    - (ii) activities which would be regulated activities but for any exclusion made by this Part.
- (2) In paragraph (1), “relevant business” means a business carried on by—
- (a) B;
  - (b) a member of the same group as B; or
  - (c) where B and another person are, or propose to become, participators in a joint enterprise, that other person.

### **Options**

83. Options to acquire or dispose of—

- (a) a security or contractually based investment (other than one of a kind specified by this article);
- (b) currency of the United Kingdom or any other country or territory;
- (c) palladium, platinum, gold or silver; or
- (d) an option to acquire or dispose of an investment of the kind specified by this article by virtue of paragraph (a), (b) or (c).

### **Futures**

84.—(1) Subject to paragraph (2), rights under a contract for the sale of a commodity or property of any other description under which delivery is to be made at a future date and at a price agreed on when the contract is made.

(2) There are excluded from paragraph (1) rights under any contract which is made for commercial and not investment purposes.

(3) A contract is to be regarded as made for investment purposes if it is made or traded on a recognised investment exchange, or is made otherwise than on a recognised investment exchange but is expressed to be as traded on such an exchange or on the same terms as those on which an equivalent contract would be made on such an exchange.

- (4) A contract not falling within paragraph (3) is to be regarded as made for commercial purposes if under the terms of the contract delivery is to be made within seven days, unless it can be shown that there existed an understanding that (notwithstanding the express terms of the contract) delivery would not be made within seven days.
- (5) The following are indications that a contract not falling within paragraph (3) or (4) is made for commercial purposes and the absence of them is an indication that it is made for investment purposes—
- (a) one or more of the parties is a producer of the commodity or other property, or uses it in his business;
  - (b) the seller delivers or intends to deliver the property or the purchaser takes or intends to take delivery of it.
- (6) It is an indication that a contract is made for commercial purposes that the prices, the lot, the delivery date or other terms are determined by the parties for the purposes of the particular contract and not by reference (or not solely by reference) to regularly published prices, to standard lots or delivery dates or to standard terms.
- (7) The following are indications that a contract is made for investment purposes—
- (a) it is expressed to be as traded on an investment exchange;
  - (b) performance of the contract is ensured by an investment exchange or a clearing house;
  - (c) there are arrangements for the payment or provision of margin.
- (8) For the purposes of paragraph (1), a price is to be taken to be agreed on when a contract is made—
- (a) notwithstanding that it is left to be determined by reference to the price at which a contract is to be entered into on a market or exchange or could be entered into at a time and place specified in the contract; or
  - (b) in a case where the contract is expressed to be by reference to a standard lot and quality, notwithstanding that provision is made for a variation in the price to take account of any variation in quantity or quality on delivery.

#### **Contracts for differences etc.**

- 85.—(1) Subject to paragraph (2), rights under—
- (a) a contract for differences; or
  - (b) any other contract the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in—
    - (i) the value or price of property of any description; or
    - (ii) an index or other factor designated for that purpose in the contract.
- (2) There are excluded from paragraph (1)—
- (a) rights under a contract if the parties intend that the profit is to be secured or the loss is to be avoided by one or more of the parties taking delivery of any property to which the contract relates;
  - (b) rights under a contract under which money is received by way of deposit on terms that any interest or other return to be paid on the sum deposited will be calculated by reference to fluctuations in an index or other factor;
  - (c) rights under any contract under which—

- (i) money is received by the Director of Savings as deposits or otherwise in connection with the business of the National Savings Bank; or
- (ii) money is raised under the National Loans Act 1968 under the auspices of the Director of Savings or treated as so raised by virtue of section 11(3) of the National Debt Act 1972;
- (d) rights under a qualifying contract of insurance.

## **Schedule 1**

### **Credit**

**14.** Contracts of insurance against risks of loss to the persons insured arising from the insolvency of debtors of theirs or from the failure (otherwise than through insolvency) of debtors of theirs to pay their debts when due.

### **Suretyship**

**15.—(1)** Contracts of insurance against the risks of loss to the persons insured arising from their having to perform contracts of guarantee entered into by them.

**(2)** Fidelity bonds, performance bonds, administration bonds, bail bonds or customs bonds or similar contracts of guarantee, where these are—

- (a) effected or carried out by a person not carrying on a banking business;
- (b) not effected merely incidentally to some other business carried on by the person effecting them; and
- (c) effected in return for the payment of one or more premiums.

### **Miscellaneous financial loss**

**16.** Contracts of insurance against any of the following risks, namely—

- (a) risks of loss to the persons insured attributable to interruptions of the carrying on of business carried on by them or to reduction of the scope of business so carried on;
- (b) risks of loss to the persons insured attributable to their incurring unforeseen expense (other than loss such as is covered by contracts falling within paragraph 18);
- (c) risks which do not fall within sub-paragraph (a) or (b) and which are not of a kind such that contracts of insurance against them fall within any other provision of this Schedule.

## **Financial Services Act 1986**

### **Section 5**

**(1)** Subject to subsection (3) below, any agreement to which this subsection applies —

- (a) which is entered into by a person in the course of carrying on investment business in contravention of section above; or
- (b) which is entered into —
  - (i) by a person who is an authorised person or an exempted person in respect of the investment business in the course of which he enters into the agreement; but

(ii) in consequence of anything said or done by a person in the course of carrying on investment business in contravention of that section, shall be unenforceable against the other party; and that party shall be entitled to recover any money or other property paid or transferred by him under the agreement, together with compensation for any loss sustained by him as a result of having parted with it.

.....

### **Section 63**

(1) No contract to which this section applies shall be void or unenforceable by reason of —

- (a) section 18 of the Gaming Act 1845, section 1 of the Gaming Act 1892 or any corresponding provisions in force in Northern Ireland; or
- (b) any rule of the law of Scotland whereby a contract by way of gaming or wagering is not legally enforceable.

(2) This section applies to any contract entered into by either or each party by way of business and the making or performance of which by either party constitutes an activity which falls within paragraph 12 of Schedule 1 to this Act or would do so apart from Parts III and IV of

### **Schedule 1, Part 1**

#### *Options*

7. Options to acquire or dispose of —

- (a) an investment falling within any other paragraph of this Part of this Schedule;
- (b) currency of the United Kingdom or of any other country or territory;
- (c) gold [palladium, platinum] or silver; or
- (d) an option to acquire or dispose of an investment falling within this paragraph by virtue of (a), (b), or (c) above.

#### *Futures*

8. Rights under a contract for the sale of a commodity or property of any other description under which delivery is to be made at a future date and at a price agreed upon when the contract is made.

#### *Notes*

- (1) This paragraph does not apply if the contract is made for commercial and not investment purposes.
- (2) A contract shall be regarded as made for investment purposes if it is made or traded on a recognised investment exchange or made otherwise than on a recognised investment exchange but expressed to be as traded on such an exchange or on the same terms as those on which an equivalent contract would be made on such an exchange.
- (3) A contract not falling within Note (2) above shall be regarded as made for commercial purposes if under the terms of the contract delivery is to be made within seven days.

- (4) The following are indications that any other contract is made for a commercial purpose and the absence of any of them is an indication that it is made for investment purposes —
- (a) either or each of the parties is a producer of the commodity or other property or uses it in his business;
  - (b) the seller delivers or intends to deliver the property or the purchaser takes or intends to take delivery of it.
- (5) It is an indication that a contract is made for commercial purposes that the prices, the lot, the delivery date or the other terms are determined by the parties for the purposes of the particular contract and not by reference to regularly published prices, to standard lots or delivery dates or to standard terms.
- (6) The following are also indications that a contract is made for investment purposes —
- (a) it is expressed to be as traded on a market or on an exchange;
  - (b) performance of the contract is ensured by an investment exchange of a clearing house;
  - (c) there are arrangements for the payment or provision of margin.
- (7) A price shall be taken to have been agreed upon when a contract is made —
- (a) notwithstanding that it is left to be determined by reference to the price at which a contract is to be entered into on a market or exchange or could be entered into at a time and place specified in the contract; or
  - (b) in a case where the contract is expressed to be by reference to a standard lot and quality, notwithstanding that provision is made for a variation in the price to take account of any variation in quantity or quality on delivery.

## Financial Services Authority Handbook

### Glossary

#### *Contract of insurance*

- (1) (in relation to a *specified investment*) the *investment*, specified in article 75 of the *Regulated Activities Order* (Contracts of insurance), which is rights under a contract of insurance in (2).
- (2) (in relation to a contract) (in accordance with article 3(1) of the *Regulated Activities Order* (Interpretation)) any contract of insurance which is a *long-term insurance contract* or a *general insurance contract*, including:
- (a) fidelity bonds, performance bonds, administration bonds, bail bonds, customs bonds or similar contracts of guarantee, where these are:
    - (i) effected or carried out by a *person* not carrying on a banking business;
    - (ii) not effected merely incidentally to some other business carried on by the *person* effecting them; and
    - (iii) effected in return for the payment of one or more premiums;
  - (b) *tontines*;
  - (c) *capital redemption* contracts or *pension fund management* contracts, where these are effected or carried out by a *person* who:



- (i) does not carry on a banking business; and
- (ii) otherwise carries on the *regulated activity* of *effecting or carrying out contracts of insurance*;
- (d) contracts to pay annuities on human life;
- (e) contracts of a kind referred to in article 2(2)(e) of the *Consolidated Life Directive* (Collective insurance etc); and
- (f) contracts of a kind referred to in article 2(3) of the *Consolidated Life Directive* (Social insurance);

but not including a *funeral plan contract* (or a contract which would be a *funeral plan contract* but for the exclusion in article 60 of the *Regulated Activities Order* (Plans covered by insurance or trust arrangements)); in this definition, "annuities on human life" does not include superannuation allowances and annuities payable out of any fund applicable solely to the relief and maintenance of *persons* engaged, or who have been engaged, in any particular profession, trade or employment, or of the dependants of such *persons*.

#### *Firm*

an *authorised person*, but not a *professional firm* unless it is an *authorised professional firm*. (see also ■ GEN 2.2.18 R for the position of an authorised partnership or unincorporated association which is dissolved.)

#### *Insurance business*

the business of *effecting or carrying out contracts of insurance*.

#### *Intermediate customer*

- (1) (except in ■ COB 3) a *client* who is not a *market counterparty* and who is:
- (a) a local authority or public authority;
  - (b) a *body corporate* whose *shares* have been *listed* or admitted to trading on any *EEA* exchange;
  - (c) a *body corporate* whose *shares* have been *listed* or admitted to trading on the primary board of any *IOSCO* member country official exchange;
  - (d) a *body corporate* (including a *limited liability partnership*) which has (or any of whose *holding companies* or *subsidiaries* has) (or has had at any time during the previous two years) called up share capital or net assets of at least £ 5 million (or its equivalent in any other currency at the relevant time);
  - (e) a *special purpose vehicle*;
  - (f) a *partnership* or unincorporated association which has (or has had at any time during the previous two years) net assets of at least £ 5 million (or its equivalent in any other currency at the relevant time) and calculated in the case of a *limited partnership* without deducting loans owing to any of the *partners*;
  - (g) a trustee of a trust (other than an *occupational pension scheme*, *SSAS*, *personal pension scheme* or *stakeholder pension scheme*) which has (or has had at any time during the previous two years) assets of at least £ 10 million (or its equivalent in any other currency at the relevant time)

calculated by aggregating the value of the cash and *designated investments* forming part of the trust's assets, but before deducting its liabilities;

(h) a trustee of an *occupational pension scheme* or *SSAS*, or a trustee or operator of a *personal pension scheme* or *stakeholder pension scheme* where the scheme has (or has had at any time during the previous two years):

(i) at least 50 members; and

(ii) assets under management of at least £ 10 million (or its equivalent in any other currency at the relevant time);

(i) another *firm*, or an *overseas financial services institution*, when, in relation to *designated investment business*, or related *ancillary activities*, conducted with or for that *firm* or institution, that *firm* or institution is an *intermediate customer* in accordance with ■ COB 4.1.7 R (Classification of another firm or an overseas financial services institution);

(j) *collective investment scheme*;

(k) a *client* when he is classified as an *intermediate customer* in accordance with ■ COB 4.1.9 R (Expert private customer classified as intermediate customer);

(l) a *recognised investment exchange*, *designated investment exchange*, *regulated market* or *clearing house*, except when it is classified as a *market counterparty* in accordance with ■ COB 4.1.8A R (Classification of an exchange or clearing house);

but excluding:

(i) [deleted]

(ii) a *client* who would otherwise be an *intermediate customer*, when he is classified in accordance with:

(A) ■ COB 4.1.12 R (Large intermediate customer classified as market counterparty); or

(B) (except for the purposes of *DISP*) ■ COB 4.1.14 R (Client classified as private customer).

(2) (in ■ COB 3) a *person* in (1) or a *person* who would be such a *person* if he were a *client*.

#### *Market counterparty*

(1) (except in ■ COB 3) a *client* who is:

(a) a properly constituted government (including a quasi-governmental body or a government agency) of any country or territory;

(b) a central bank or other national monetary authority of any country or territory;

(c) a supranational whose members are either countries or central banks or national monetary authorities;

(d) a State investment body, or a body charged with, or intervening in, the management of the public debt;

(e) another *firm*, or an *overseas financial services institution*, except in relation to *designated investment business*, and related *ancillary activities*, conducted with or for that *firm* or institution, when that *firm* or institution is an *intermediate customer* in accordance with ■ COB 4.1.7 R (Classification of another firm or an overseas financial services institution);

- (f) any *associate* of a *firm* (except an *OPS firm*), or of an *overseas financial services institution*, if the *firm* or institution consents;
- (g) a *client* when he is classified as a *market counterparty* in accordance with ■ COB 4.1.12 R (Large intermediate customer classified as a market counterparty);
- (h) a *recognised investment exchange*, *designated investment exchange*, *regulated market* or *clearing house* when it is classified as a *market counterparty* in accordance with ■ COB 4.1.8A R (Classification of an exchange or clearing house);

but excluding:

- (A) a *regulated collective investment scheme*; and
  - (B) (except for the purposes of *DISP*) a *client*, who would otherwise be a *market counterparty*, when he is classified as a *private customer* in accordance with ■ COB 4.1.14 R (Client classified as private customer).
- (2) (in ■ COB 3) a *person* in (1) and a *person* who would be such a *person* if he were a *client*.

#### *Private customer*

(1) (except in ■ COB 3, ■ COB 4.2 and ■ COB 6.4) subject to (h), a *client* who is not a market counterparty or an *intermediate customer*, including:

- (a) an individual who is not a *firm* ;
- (b) an overseas individual who is not an *overseas financial services institution*;
- (c) [deleted]
- (d) (except for the purposes of *DISP*) a *client* when he is classified as a *private customer* in accordance with ■ COB 4.1.14 R (Client classified as a private customer);
- (e) a *person* to whom a *firm* provides basic advice on stakeholder products;
- (f) (in ■ COB 6.1 to ■ 6.5) where the *regulated activity* (except for a personal recommendation relating to a contribution to a *CTF* ) relates to a *CTF* and there is no *registered contact* , the *person* to whom the annual statement must be sent in accordance with Regulation 10 of the *CTF* Regulations;
- (g) (in ■ COB 6.7) where the *regulated activity* (except for a personal recommendation relating to a contribution to a *CTF*) relates to a *CTF* and there is no *registered contact*, the child, via the person to whom the annual statement must be sent in accordance with Regulation 10 of the *CTF* Regulations;
- (h) a *client* who would otherwise be excluded as a market counterparty or *intermediate customer* if the *client* is within (e), (f) or (g);

but excluding a *client* , who would otherwise be a *private customer*:

- (i) when he is classified as an *intermediate customer* in accordance with ■ COB 4.1.9 R (Expert private customer classified as an intermediate customer); or
  - (ii) when the *regulated activity* relates to a *CTF* , any *person* other than (e), (f), (g) or (h).
- (2) (in ■ COB 3) a *person* in (1) or a *person* excluded under (1)(h)(ii) or a *person* who would be such a *person* if he were a *client*. (in ■ COB 4.2 and 6.1

to 6.5) a *person* in (1) and, in relation to the conclusion of a *distance contract* , a *retail customer*.

(3) (in ■ COB 4.2 and ■ 6.1 to ■ 6.5) a *person* in (1) and, in relation to the conclusion of a *distance contract*, a *retail customer*.

### **INSPRU 3.2.5 Derivatives and quasi-derivatives**

For the purpose of ■ GENPRU 2 Annex 7 R (Admissible assets in insurance), and also in relation to permitted links, a derivative or quasi-derivative is approved if:

(1) it is held for the purpose of efficient portfolio management (■ INSPRU 3.2.6 R to ■ INSPRU 3.2.7 R) or reduction of investment risk (■ INSPRU 3.2.8 R to ■ INSPRU 3.2.13 G);

(2) it is covered ( ■ INSPRU 3.2.14 R to ■ INSPRU 3.2.33 G); and

(3) it is effected or issued:

(a) on or under the rules of a regulated market; or

(b) off-market with an approved counterparty and, except for a forward transaction, on approved terms and is capable of valuation ( ■ INSPRU 3.2.34 R to ■ INSPRU 3.2.35 R).

### **ELM 3.7 Derivatives**

#### **ELM 3.7.1**

A firm must not be a party to or have a position in a derivative or quasi derivative contract unless ELM 3.7.2 R allows this.

#### **ELM 3.7.2**

A firm may be a party to a derivative or quasi derivative contract if:

(1) the sole purpose (ignoring any other purposes which together are insignificant) of becoming a party to it is hedging market risks arising from:

(a) issuing e-money; or

(b) the e-money float;

(2) so far as reasonably possible, being a party to that derivative or quasi derivative contract achieves the permitted purpose described in ELM 3.7.2 R

(1);

(3) the derivative or quasi derivative contract is sufficiently liquid; and

(4) either:

(a) the derivative or quasi derivative contract is an exchange rate contract relating to a foreign currency with an original maturity of 14 days or less; or

(b) the derivative or quasi derivative contract:

(i) is an interest rate or foreign exchange related contract;

(ii) is regularly traded on a recognised investment exchange or designated investment exchange; and

(iii) is subject to daily margin requirements under the rules of that exchange.

## **Building Societies Act 1986**

### **9A Restrictions on certain transactions]**

(1) Subject to subsections (2) to (4) below, a building society shall not do, and shall secure that each of its subsidiary undertakings does not do, any of the following things, namely—

- (a) act as a market maker in securities, commodities or currencies;
  - (b) trade in commodities or currencies; and
  - (c) enter into any transaction involving derivative investments;
- but a contravention of this subsection shall not invalidate any transaction or other act.

(2) No transaction entered into by a building society, or a subsidiary undertaking of a building society, shall be taken into account for the purposes of subsection (1)(a) above if—

- (a) it relates only to securities or currencies or both and the amount or value of the consideration given by the society or undertaking does not exceed £100,000; or
- (b) it is entered into in the society's or undertaking's capacity as the manager of a collective investment scheme.

(3) No transaction so entered into shall be taken into account for the purposes of subsection (1)(b) above if—

- (a) it relates only to currencies and the amount or value of the consideration given by the society or undertaking does not exceed £100,000; or
- (b) it is ancillary or incidental to another transaction entered into by the society or undertaking.

(4) Nothing in subsection (1)(c) above shall apply in relation to any transaction entered into by a building society, or a subsidiary undertaking of a building society, if—

- (a) it is entered into in the society's or undertaking's capacity as the manager of a collective investment scheme;
- (b) it is entered into for the purpose of limiting the extent to which the society, or a connected undertaking of the society, will be affected by changes in any of the following factors, namely—
  - (i) interest rates;
  - (ii) exchange rates;
  - (iii) any index of retail prices;
  - (iv) any index of residential property prices; . . .
  - (v) any index of the prices of securities; [and
  - (vi) the ability or willingness of one or more persons to pay or repay a sum or sums owing at law or in equity to the society or a connected undertaking of the society;] or
- (c) it involves a derivative investment falling within paragraph (d) of the definition in subsection (9) below and it is entered into for the purpose of limiting the extent to which any person will be affected by changes in any interest or exchange rate applicable to—
  - (i) a loan owed by him to;
  - (ii) shares held by him in; or
  - (iii) a deposit of his with,the society, or a connected undertaking of the society.

(5) Nothing in subsection (1)(c) above shall apply in relation to any transaction entered into by a subsidiary undertaking of a building society, if it is entered into in the undertaking's capacity—

[(a) as a person who has permission under Part IV of the Financial Services and Markets Act 2000 to effect or carry out contracts of long-term insurance, or

(b) an EEA firm of the kind mentioned in paragraph 5(d) of Schedule 3 to that Act, which has permission under paragraph 15 of that Schedule (as a result of qualifying for authorisation under paragraph 12 of that Schedule) to effect or carry out contracts of long-term insurance;]

....

(6) A building society shall also do all that is reasonably practicable to secure that neither it nor any of its subsidiary undertakings (either alone or with any or any others of those undertakings)—

(a) holds at any time more than 5 per cent of the issued share capital; or

(b) is at any time entitled to exercise, or to control the exercise of, more than 5 per cent of the voting power at any general meeting, of an undertaking which is, at that time, doing any of the things which the society is prohibited from doing by subsection (1) above, or an undertaking whose subsidiary undertaking is, at that time, doing any of those things.

(7) The monetary limit in subsection (2) or (3) above refers to the time when the transaction is entered into; and where the amount or value of the consideration there referred to is not in sterling, it shall be converted at the rate of exchange prevailing at that time.

(8) For the purposes of subsection (2) or (3) above, two or more transactions which form part of a larger transaction or series of transactions shall be treated as a single transaction.

(9) In this section—

“collective investment scheme” has the same meaning as in the [Financial Services and Markets Act 2000];

“commodity” means any produce of agriculture, forestry or fisheries, or any mineral, either in its natural state or having undergone only such processes as are necessary or customary to prepare the produce or mineral for the market;

[“derivative investment” means an investment of the following kinds—

(a) instruments giving entitlements to investments;

(b) options;

(c) futures;

(d) contracts for differences;]

“market maker” means, subject to subsection (10) below, a person who holds himself out as willing at all normal times to buy or sell at a price specified by him securities, commodities or currencies of a particular description;

“securities” means shares, stock, debentures, debenture stock, loan stock, bonds, units of a collective investment scheme and other securities of any description.

[(9A) Subsection (5) and the definition of “derivative investment” in subsection (9) must be read with—

(a) section 22 of the Financial Services and Markets Act 2000;

(b) any relevant order under that section; and

(c) Schedule 2 to that Act.]

(10) A building society, or subsidiary undertaking of a building society, shall not by reason of holding itself out as willing to issue its own securities be

regarded for the purposes of this section as acting as a market maker in such securities.

(11) The Treasury may by order vary subsections (1) to (10) above by adding to or deleting from them any provision or by varying any provision contained in them.

(12) [The Treasury may] by order—

(a) substitute for the amount specified in subsection (2) or (3) above, or for the percentage specified in subsection (6) above, such other amount or percentage as [they think] appropriate; or

(b) vary subsection (4)(b) above by adding to or deleting from it any reference to a factor or by varying any reference to a factor contained in it.

(13) An order under subsection (11) or (12) above may make—

(a) different provision for different cases or purposes; and

(b) such supplementary, transitional and saving provision as appears to the Treasury . . . to be necessary or expedient; and the power to make such an order is exercisable by statutory instrument.

(14) No order shall be made under subsection (11) above unless a draft of the order has been laid before and approved by a resolution of each House of Parliament.

(15) A statutory instrument containing an order under subsection (12) above shall be subject to annulment in pursuance of a resolution of either House of Parliament.

## **Gambling Act 2005**

### **1 The licensing objectives**

In this Act a reference to the licensing objectives is a reference to the objectives of—

(a) preventing gambling from being a source of crime or disorder, being

associated with crime or disorder or being used to support crime,

(b) ensuring that gambling is conducted in a fair and open way, and

(c) protecting children and other vulnerable persons from being harmed or exploited by gambling.

### **3 Gambling**

In this Act “gambling” means—

(a) gaming (within the meaning of section 6),

(b) betting (within the meaning of section 9), and

(c) participating in a lottery (within the meaning of section 14 and subject to section 15).

### **6 Gaming & game of chance**

(1) In this Act “gaming” means playing a game of chance for a prize.

(2) In this Act “game of chance”—

(a) includes—

(i) a game that involves both an element of chance and an element of

- skill,
- (ii) a game that involves an element of chance that can be eliminated by superlative skill, and
- (iii) a game that is presented as involving an element of chance, but (b) does not include a sport.
- (3) For the purposes of this Act a person plays a game of chance if he participates in a game of chance—
  - (a) whether or not there are other participants in the game, and
  - (b) whether or not a computer generates images or data taken to represent the actions of other participants in the game.
- (4) For the purposes of this Act a person plays a game of chance for a prize—
  - (a) if he plays a game of chance and thereby acquires a chance of winning a prize, and
  - (b) whether or not he risks losing anything at the game.
- (5) In this Act “prize” in relation to gaming (except in the context of a gaming machine)—
  - (a) means money or money’s worth, and
  - (b) includes both a prize provided by a person organising gaming and winnings of money staked.
- (6) The Secretary of State may by regulations provide that a specified activity, or an activity carried on in specified circumstances, is or is not to be treated for the purposes of this Act as—
  - (a) a game;
  - (b) a game of chance;
  - (c) a sport.

## **9 Betting: general**

- (1) In this Act “betting” means making or accepting a bet on—
  - (a) the outcome of a race, competition or other event or process,
  - (b) the likelihood of anything occurring or not occurring, or
  - (c) whether anything is or is not true.
- (2) A transaction that relates to the outcome of a race, competition or other event or process may be a bet within the meaning of subsection (1) despite the facts that—
  - (a) the race, competition, event or process has already occurred or been completed, and
  - (b) one party to the transaction knows the outcome.
- (3) A transaction that relates to the likelihood of anything occurring or not occurring may be a bet within the meaning of subsection (1) despite the facts that—
  - (a) the thing has already occurred or failed to occur, and
  - (b) one party to the transaction knows that the thing has already occurred or failed to occur.

## **10 Spread bets, etc.**

- (1) For the purposes of section 9(1) “bet” does not include a bet the making or accepting of which is a regulated activity within the meaning of section 22 of the Financial Services and Markets Act 2000 (c. 8).



- (2) An order under section 22 of that Act which has the effect that a class of bet becomes or ceases to be a regulated activity may, in particular, include transitional provision relating to the application of this Act to that class of bet.
- (3) This section is subject to section 38(3).

## **12 Pool betting**

- (1) For the purposes of this Act betting is pool betting if made on terms that all or part of winnings—
  - (a) shall be determined by reference to the aggregate of stakes paid or agreed to be paid by the persons betting,
  - (b) shall be divided among the winners, or
  - (c) shall or may be something other than money.
- (2) For the purposes of this Act pool betting is horse-race pool betting if it relates to horse-racing in Great Britain.

## **13 Betting intermediary**

- (1) In this Act “betting intermediary” means a person who provides a service designed to facilitate the making or acceptance of bets between others.
- (2) For the purposes of this Act acting as a betting intermediary is providing facilities for betting.

## **296 Exceptions to offences**

- (1) A person does not commit an offence under section 33 by providing facilities for—
  - (a) private gaming, or
  - (b) private betting.
- (2) Section 37 shall not apply to or in respect of the use of premises to carry on—
  - (a) private gaming, or
  - (b) private betting.
- (3) A person does not commit an offence under section 33 or 37 by making or accepting a bet, or by offering to make or accept a bet, if he acts otherwise than in the course of a business.

### *Non-commercial gaming and betting*

## **297 Interpretation**

- (1) For the purposes of this Act gaming is non-commercial if it takes place at a noncommercial event (whether as an incidental activity or as the principal or only activity).
- (2) An event is non-commercial if the arrangements for the event are such that no part of the proceeds is to be appropriated for the purpose of private gain.
- (3) For the purposes of subsection (2) the proceeds of an event are—
  - (a) the sums raised by the organisers (whether by way of fees for entrance or for participation, by way of sponsorship, by way of commission from traders or otherwise), minus
  - (b) amounts deducted by the organisers in respect of costs reasonably incurred in organising the event.

### **302 Non-commercial betting**

For the purposes of this Act a betting transaction is non-commercial betting if no party to the transaction—

- (a) enters it in the course of a business, or
- (b) holds himself out as being in business in relation to the acceptance of bets.

### **334 Repeal of provisions preventing enforcement**

(1) The following shall cease to have effect—

- (a) section 1 of the Gaming Act 1710 (c. 19) (voiding of security for winnings or for repayment of gaming loan, etc.),
- (b) remaining provisions of the Gaming Act 1835 (c. 41) (security deemed given for illegal consideration),
- (c) section 18 of the Gaming Act 1845 (c. 109) (voiding of gaming contracts),
- (d) section 1 of the Gaming Act 1892 (c. 9) (voiding of promise to repay), and
- (e) in section 412 of the Financial Services and Markets Act 2000 (c. 8) (gaming contracts)—
  - (i) in subsection (1)(a), the words “section 18 of the Gaming Act 1845, section 1 of the Gaming Act 1892 or”, and
  - (ii) subsection (1)(b).

(2) The repeals in subsection (1) do not permit enforcement of a right which is created, or which emanates from an agreement made, before this section comes into force.

### **335 Enforceability of gambling contracts**

- (1) The fact that a contract relates to gambling shall not prevent its enforcement.
- (2) Subsection (1) is without prejudice to any rule of law preventing the enforcement of a contract on the grounds of unlawfulness (other than a rule relating specifically to gambling).

## **SCHEDULE 15**

### **PRIVATE GAMING AND BETTING**

#### **PART 1**

#### **GAMING**

##### *Introduction*

1 Gaming is private if it satisfies the conditions specified in this Part of this Schedule.

2 (1) For the purposes of this Part of this Schedule gaming is domestic if it takes place—

- (a) in a private dwelling, and
- (b) on a domestic occasion.

(2) For the purposes of this Part of this Schedule gaming is residential if—

- (a) it takes place in a hostel, hall of residence or similar establishment which is not administered in the course of a trade or business, and
- (b) more than half of the participants are residents of the hostel, hall or

establishment.

*No charge for participation*

3 (1) It is a condition of private gaming that no charge is made for participation.

(2) For the purposes of this paragraph—

- (a) it is immaterial how a charge is described,
- (b) it is immaterial whether a charge is in money or money's worth,
- (c) an amount deducted or levied, by a person providing facilities for gaming, from sums staked or won in the course of gaming is a charge for participation in the gaming,
- (d) a charge for admission to premises where gaming takes place shall be treated as a charge for participation in the gaming, and
- (e) a stake is not a charge for participation.

*Equal chance gaming*

4 (1) It is a condition of private gaming that it is equal chance gaming.

(2) But this condition does not apply in relation to domestic or residential gaming.

*Privacy*

5 It is a condition of private gaming that it does not occur in a place to which the public have access (whether or not on payment).

PART 2

BETTING

*Introduction*

6 Betting is private betting if it is—

- (a) domestic betting, or
- (b) workers' betting.

*Domestic betting*

7 (1) A betting transaction is domestic betting if made on premises in which each party to the transaction lives.

(2) For the purposes of this paragraph a person lives in premises if he habitually resides in any part of the premises (whether or not there are other premises in which he also habitually resides).

*Workers' betting*

8 A betting transaction is workers' betting if made between persons each of whom is employed under a contract of employment with the same employer.

## Appendix 2 Selected US Statutes

### Commodity Exchange Act

#### 7 USCS 1a. Definitions

...

(2) Board of trade. The term "board of trade" means any organized exchange or other trading facility.

...

(4) Commodity. The term "commodity" means wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, *Solanum tuberosum* (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions as provided in Public Law 85-839 (*7 U.S.C. 13-1*), and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.

...

(7) Contract of sale. The term "contract of sale" includes sales, agreements of sale, and agreements to sell.

...

(11) Eligible commercial entity. The term "eligible commercial entity" means, with respect to an agreement, contract or transaction in a commodity--

(A) an eligible contract participant described in clause (i), (ii), (v), (vii), (viii), or (ix) of paragraph (12)(A) that, in connection with its business--

(i) has a demonstrable ability, directly or through separate contractual arrangements, to make or take delivery of the underlying commodity;

(ii) incurs risks, in addition to price risk, related to the commodity;

or

(iii) is a dealer that regularly provides risk management or hedging services to, or engages in market-making activities with, the foregoing entities involving transactions to purchase or sell the commodity or derivative agreements, contracts, or transactions in the commodity;

(B) an eligible contract participant, other than a natural person or an instrumentality, department, or agency of a State or local governmental entity, that--

(i) regularly enters into transactions to purchase or sell the commodity or derivative agreements, contracts, or transactions in the commodity; and

(ii) either--

(I) in the case of a collective investment vehicle whose participants include persons other than--

(aa) qualified eligible persons, as defined in Commission rule 4.7(a) (17 CFR 4.7(a));

(bb) accredited investors, as defined in Regulation D of the Securities and Exchange Commission under the Securities Act of 1933 (17 CFR 230.501(a)), with total assets of \$ 2,000,000; or

(cc) qualified purchasers, as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 [15 USCS § 80a-2(a)(51)(A)];

in each case as in effect on the date of the enactment of the Commodity Futures Modernization Act of 2000 [enacted Dec. 21, 2000], has, or is one of a group of vehicles under common control or management having in the aggregate, \$ 1,000,000,000 in total assets; or

(II) in the case of other persons, has, or is one of a group of persons under common control or management having in the aggregate, \$ 100,000,000 in total assets; or

(C) such other persons as the Commission shall determine appropriate and shall designate by rule, regulation, or order.

(12) Eligible contract participant. The term "eligible contract participant" means--

(A) acting for its own account--

(i) a financial institution;

(ii) an insurance company that is regulated by a State, or that is regulated by a foreign government and is subject to comparable regulation as determined by the Commission, including a regulated subsidiary or affiliate of such an insurance company;

(iii) an investment company subject to regulation under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) or a foreign person performing a similar role or function subject as such to foreign regulation (regardless of whether each investor in the investment company or the foreign person is itself an eligible contract participant);

(iv) a commodity pool that--

(I) has total assets exceeding \$ 5,000,000; and

(II) is formed and operated by a person subject to regulation under this Act [7 USCS §§ 1 et seq.] or a foreign person performing a similar role or function subject as such to foreign regulation (regardless of whether each investor in the commodity pool or the foreign person is itself an eligible contract participant);

(v) a corporation, partnership, proprietorship, organization, trust, or other entity--

(I) that has total assets exceeding \$ 10,000,000;

(II) the obligations of which under an agreement, contract, or transaction are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement by an entity described in subclause (I), in clause (i), (ii), (iii), (iv), or (vii), or in subparagraph (C); or

(III) that--

(aa) has a net worth exceeding \$ 1,000,000; and

(bb) enters into an agreement, contract, or transaction in connection with the conduct of the entity's business or to manage the risk

associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business;

(vi) an employee benefit plan subject to the Employee Retirement Income Security Act of 1974 (*29 U.S.C. 1001 et seq.*), a governmental employee benefit plan, or a foreign person performing a similar role or function subject as such to foreign regulation--

(I) that has total assets exceeding \$ 5,000,000; or

(II) the investment decisions of which are made by--

(aa) an investment adviser or commodity trading advisor subject to regulation under the Investment Advisers Act of 1940 (*15 U.S.C. 80b-1 et seq.*) or this Act [*7 USCS §§ 1 et seq.*];

(bb) a foreign person performing a similar role or function subject as such to foreign regulation;

(cc) a financial institution; or

(dd) an insurance company described in clause (ii), or a regulated subsidiary or affiliate of such an insurance company;

(vii) (I) a governmental entity (including the United States, a State, or a foreign government) or political subdivision of a governmental entity;

(II) a multinational or supranational government entity; or

(III) an instrumentality, agency, or department of an entity described in subclause (I) or (II);

except that such term does not include an entity, instrumentality, agency, or department referred to in subclause (I) or (III) of this clause unless (aa) the entity, instrumentality, agency, or department is a person described in clause (i), (ii), or (iii) of section 1a(11)(A); (bb) the entity, instrumentality, agency, or department owns and invests on a discretionary basis \$ 25,000,000 or more in investments; or (cc) the agreement, contract, or transaction is offered by, and entered into with, an entity that is listed in any of subclauses (I) through (VI) of section 2(c)(2)(B)(ii);

(viii)

(I) a broker or dealer subject to regulation under the Securities Exchange Act of 1934 (*15 U.S.C. 78a et seq.*) or a foreign person performing a similar role or function subject as such to foreign regulation, except that, if the broker or dealer or foreign person is a natural person or proprietorship, the broker or dealer or foreign person shall not be considered to be an eligible contract participant unless the broker or dealer or foreign person also meets the requirements of clause (v) or (xi);

(II) an associated person of a registered broker or dealer concerning the financial or securities activities of which the registered person makes and keeps records under section 15C(b) or 17(h) of the Securities Exchange Act of 1934 (*15 U.S.C. 78o 5(b), 78q(h)*);

(III) an investment bank holding company (as defined in section 17(i) of the Securities Exchange Act of 1934 (*15 U.S.C. 78q(i)*));

(ix) a futures commission merchant subject to regulation under this Act [*7 USCS §§ 1 et seq.*] or a foreign person performing a similar role or function subject as such to foreign regulation, except that, if the futures commission merchant or foreign person is a natural person or proprietorship, the futures commission merchant or foreign person shall not be considered to be

an eligible contract participant unless the futures commission merchant or foreign person also meets the requirements of clause (v) or (xi);

(x) a floor broker or floor trader subject to regulation under this Act [7 USCS §§ 1 et seq.] in connection with any transaction that takes place on or through the facilities of a registered entity or an exempt board of trade, or any affiliate thereof, on which such person regularly trades; or

(xi) an individual who has total assets in an amount in excess of--

(I) \$ 10,000,000; or

(II) \$ 5,000,000 and who enters into the agreement, contract, or transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred, by the individual;

(B)

(i) a person described in clause (i), (ii), (iv), (v), (viii), (ix), or (x) of subparagraph (A) or in subparagraph (C), acting as broker or performing an equivalent agency function on behalf of another person described in subparagraph (A) or (C); or

(ii) an investment adviser subject to regulation under the Investment Advisers Act of 1940 [15 USCS §§ 80b et seq.], a commodity trading advisor subject to regulation under this Act [7 USCS §§ 1 et seq.], a foreign person performing a similar role or function subject as such to foreign regulation, or a person described in clause (i), (ii), (iv), (v), (viii), (ix), or (x) of subparagraph (A) or in subparagraph (C), in any such case acting as investment manager or fiduciary (but excluding a person acting as broker or performing an equivalent agency function) for another person described in subparagraph (A) or (C) and who is authorized by such person to commit such person to the transaction; or

(C) any other person that the Commission determines to be eligible in light of the financial or other qualifications of the person.

(13) Excluded commodity. The term "excluded commodity" means--

(i) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure;

(ii) any other rate, differential, index, or measure of economic or commercial risk, return, or value that is--

(I) not based in substantial part on the value of a narrow group of commodities not described in clause (i); or

(II) based solely on 1 or more commodities that have no cash market;

(iii) any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or

(iv) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is--

(I) beyond the control of the parties to the relevant contract, agreement, or transaction; and

(II) associated with a financial, commercial, or economic consequence.

...

(16) Floor broker. The term "floor broker" means any person who, in or surrounding any pit, ring, post, or other place provided by a contract market or derivatives transaction execution facility for the meeting of persons similarly engaged, shall purchase or sell for any other person any commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility.

(17) Floor trader. The term "floor trader" means any person who, in or surrounding any pit, ring, post, or other place provided by a contract market or derivatives transaction execution facility for the meeting of persons similarly engaged, purchases, or sells solely for such person's own account, any commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility.

...

(19) Future delivery. The term "future delivery" does not include any sale of any cash commodity for deferred shipment or delivery.

(20) Futures commission merchant. The term "futures commission merchant" means an individual, association, partnership, corporation, or trust that--

(A) is engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility; and

(B) in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.

(21) Hybrid instrument. The term "hybrid instrument" means a security having 1 or more payments indexed to the value, level, or rate of, or providing for the delivery of, 1 or more commodities.

...

(26) Option. The term "option" means an agreement, contract, or transaction that is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty".

(27) Organized exchange. The term "organized exchange" means a trading facility that--

(A) permits trading--

(i) by or on behalf of a person that is not an eligible contract participant; or

(ii) by persons other than on a principal-to-principal basis; or

(B) has adopted (directly or through another nongovernmental entity) rules that--

(i) govern the conduct of participants, other than rules that govern the submission of orders or execution of transactions on the trading facility; and

(ii) include disciplinary sanctions other than the exclusion of participants from trading.

.....



**7 USCS 2. Jurisdiction of Commission; liability of principal for act of agent; Commodity Futures Trading Commission; transaction in interstate commerce**

(a) Jurisdiction of Commission; Commodity Futures Trading Commission.

(1) Jurisdiction of Commission.

(A) In general. The Commission shall have exclusive jurisdiction, except to the extent otherwise provided in subparagraphs (C) and (D) of this paragraph and subsections (c) through (i) of this section, with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty"), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated or derivatives transaction execution facility registered pursuant to section 5 or 5a [7 USCS § 7 or 7a] or any other board of trade, exchange, or market, and transactions subject to regulation by the Commission pursuant to section 19 of this Act [7 USCS § 23]. Except as hereinabove provided, nothing contained in this section shall (I) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State, or (II) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws. Nothing in this section shall supersede or limit the jurisdiction conferred on courts of the United States or any State.

(B) Liability of principal for act of agent. The act, omission, or failure of any official, agent, or other person acting for any individual, association, partnership, corporation, or trust within the scope of his employment or office shall be deemed the act, omission, or failure of such individual, association, partnership, corporation, or trust, as well as of such official, agent, or other person.

(C) Designation of boards of trade as contract markets; contracts for future delivery; security futures products; filing with Board of Governors of Federal Reserve System; judicial review. Notwithstanding any other provision of law--

(i) This Act [7 USCS §§ 1 et seq.] shall not apply to and the Commission shall have no jurisdiction to designate a board of trade as a contract market for any transaction whereby any party to such transaction acquires any put, call, or other option on one or more securities (as defined in section 2(1) of the Securities Act of 1933 [15 USCS § 77b(a)(1)] or section 3(a)(10) of the Securities Exchange Act of 1934 [15 USCS §§ 77c(a)(10)] on the date of enactment of the Futures Trading Act of 1982 [enacted Jan. 11, 1983]), including any group or index of such securities, or any interest therein or based on the value thereof.

(ii) This Act [7 USCS §§ 1 et seq.] shall apply to and the Commission shall have exclusive jurisdiction with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty") and

transactions involving, and may designate a board of trade as a contract market in, or register a derivatives transaction execution facility that trades or executes, contracts of sale (or options on such contracts) for future delivery of a group or index of securities (or any interest therein or based upon the value thereof): *Provided, however,* That no board of trade shall be designated as a contract market with respect to any such contracts of sale (or options on such contracts) for future delivery, and no derivatives transaction execution facility shall trade or execute such contracts of sale (or options on such contracts) for future delivery, unless the board of trade or the derivatives transaction execution facility, and the applicable contract, meet the following minimum requirements:

(I) Settlement of or delivery on such contract (or option on such contract) shall be effected in cash or by means other than the transfer or receipt of any security, except an exempted security under section 3 of the Securities Act of 1933 [15 USCS § 77c] or *section 3(a)(12)* of the Securities Exchange Act of 1934 [15 USCS § 78c(a)(12)] as in effect on the date of enactment of the Futures Trading Act of 1982 [enacted Jan. 11, 1983] (other than any municipal security, as defined in section 3(a)(29) of the Securities Exchange Act of 1934 [15 USCS § 78c(a)(29)] on the date of enactment of the Futures Trading Act of 1982 [enacted Jan. 11, 1983]);

(II) Trading in such contract (or option on such contract) shall not be readily susceptible to manipulation of the price of such contract (or option on such contract), nor to causing or being used in the manipulation of the price of any underlying security, option on such security or option on a group or index including such securities; and

(III) Such group or index of securities shall not constitute a narrow-based security index.

(iii) If, in its discretion, the Commission determines that a stock index futures contract, notwithstanding its conformance with the requirements in clause (ii) of this subparagraph, can reasonably be used as a surrogate for trading a security (including a security futures product), it may, by order, require such contract and any option thereon be traded and regulated as security futures products as defined in section 3(a)(56) of the Securities Exchange Act of 1934 [15 USCS § 78c(a)(56)] and section 1a of this Act [7 USCS § 1a] subject to all rules and regulations applicable to security futures products under this Act [7 USCS §§ 1 et seq.] and the securities laws as defined in section 3(a)(47) of the Securities Exchange Act of 1934 [15 USCS §§ 78c(a)(47)].

(iv) No person shall offer to enter into, enter into, or confirm the execution of any contract of sale (or option on such contract) for future delivery of any security, or interest therein or based on the value thereof, except an exempted security under [or] section 3(a)(12) of the Securities Exchange Act of 1934 [15 USCS § 78c(a)(12)] as in effect on the date of enactment of the Futures Trading Act of 1982 [enacted Jan. 11, 1983] (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 [15 USCS § 78c(a)(29)] on the date of enactment of the Futures Trading Act of 1982 [enacted Jan. 11, 1983]), or except as provided in clause (ii) of this subparagraph or subparagraph (D), any group or index of such securities or any interest therein or based on the value thereof.

(v) (I) Notwithstanding any other provision of this Act [7 USCS §§ 1 et seq.], any contract market in a stock index futures contract (or option thereon) other than a security futures product, or any derivatives transaction execution facility on which such contract or option is traded, shall file with the Board of Governors of the Federal Reserve System any rule establishing or changing the levels of margin (initial and maintenance) for such stock index futures contract (or option thereon) other than security futures products.

(II) The Board may at any time request any contract market or derivatives transaction execution facility to set the margin for any stock index futures contract (or option thereon), other than for any security futures product, at such levels as the Board in its judgment determines are appropriate to preserve the financial integrity of the contract market or derivatives transaction execution facility, or its clearing system, or to prevent systemic risk. If the contract market or derivatives transaction execution facility fails to do so within the time specified by the Board in its request, the Board may direct the contract market or derivatives transaction execution facility to alter or supplement the rules of the contract market or derivatives transaction execution facility as specified in the request.

(III) Subject to such conditions as the Board may determine, the Board may delegate any or all of its authority, relating to margin for any stock index futures contract (or option thereon), other than security futures products, under this clause to the Commission.

(IV) It shall be unlawful for any futures commission merchant to, directly or indirectly, extend or maintain credit to or for, or collect margin from any customer on any security futures product unless such activities comply with the regulations prescribed pursuant to section 7(c)(2)(B) of the Securities Exchange Act of 1934 [15 USCS § 78g(c)(2)(B)].

(V) Nothing in this clause shall supersede or limit the authority granted to the Commission in section 8a(9) [7 USCS § 12a] to direct a contract market or registered derivatives transaction execution facility, on finding an emergency to exist, to raise temporary margin levels on any futures contract, or option on the contract covered by this clause, or on any security futures product.

(VI) Any action taken by the Board, or by the Commission acting under the delegation of authority under subclause III [(III)], under this clause directing a contract market to alter or supplement a contract market rule shall be subject to review only in the Court of Appeals where the party seeking review resides or has its principal place of business, or in the United States Court of Appeals for the District of Columbia Circuit. The review shall be based on the examination of all information before the Board or the Commission, as the case may be, at the time the determination was made. The court reviewing the action of the Board or the Commission shall not enter a stay or order of mandamus unless the court has determined, after notice and a hearing before a panel of the court, that the agency action complained of was arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.

...

(g) Excluded swap transactions. No provision of this Act [7 USCS §§ 1 et seq.] (other than section 5a (to the extent provided in section 5a(g)), 5b, 5d, or

12(e)(2) [7 USCS § 7a, 7a-1, 7a-3, or 16(e)(2)]) shall apply to or govern any agreement, contract, or transaction in a commodity other than an agricultural commodity if the agreement, contract, or transaction is--

- (1) entered into only between persons that are eligible contract participants at the time they enter into the agreement, contract, or transaction;
- (2) subject to individual negotiation by the parties; and
- (3) not executed or traded on a trading facility.

#### **7 USCS 6. Regulation of futures trading and foreign transactions**

(a) Restriction on futures trading. Unless exempted by the Commission pursuant to subsection (c), it shall be unlawful for any person to offer to enter into, to enter into, to execute, to confirm the execution of, or to conduct any office or business anywhere in the United States, its territories or possessions, for the purpose of soliciting or accepting any order for, or otherwise dealing in, any transaction in, or in connection with, a contract for the purchase or sale of a commodity for future delivery (other than a contract which is made on or subject to the rules of a board of trade, exchange, or market located outside the United States, its territories or possessions) unless--

(1) such transaction is conducted on or subject to the rules of a board of trade which has been designated or registered by the Commission as a contract market or derivatives transaction execution facility for such commodity;

(2) such contract is executed or consummated by or through a contract market; and

(3) such contract is evidenced by a record in writing which shows the date, the parties to such contract and their addresses, the property covered and its price, and the terms of delivery: *Provided*, That each contract market or derivatives transaction execution facility member shall keep such record for a period of three years from the date thereof, or for a longer period if the Commission shall so direct, which record shall at all times be open to the inspection of any representative of the Commission or the Department of Justice.

.....

### **Securities Act of 1933**

#### **15 USCS 77b. Definitions**

(a) Definitions. When used in this title [15 USCS §§ 77a et seq.] unless the context otherwise requires----

(1) The term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle,

option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

.....

## **Securities Exchange Act of 1934**

### **15 USCS 78j. Manipulative and deceptive devices**

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange----

(a)

(1) To effect a short sale, or to use or employ any stop--loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(2) Paragraph (1) of this subsection shall not apply to security futures products.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities--based swap agreement (as defined in section 206B of the Gramm--Leach--Bliley Act [*15 USCS § 78c* note]), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rules promulgated under subsection (b) that prohibit fraud, manipulation, or insider trading (but not rules imposing or specifying reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading), and judicial precedents decided under subsection (b) and rules promulgated thereunder that prohibit fraud, manipulation, or insider trading, shall apply to security--based swap agreements (as defined in section 206B of the Gramm--Leach--Bliley Act [*15 USCS § 78c* note]) to the same extent as they apply to securities. Judicial precedents decided under section 17(a) of the Securities Act of 1933 [*15 USCS § 77q(a)*] and *sections 9, 15, 16, 20, and 21A* of this *title* [*15 USCS §§ 78i, 78o, 78p, 78t, and 78u--1*], and judicial precedents decided under applicable rules promulgated under such sections, shall apply to security--based swap agreements (as defined in section 206B of the Gramm--Leach--Bliley Act [*15 USCS § 78c* note]) to the same extent as they apply to securities.

### **SEC Rule 10b-5**

**17 CFR 240.10b--5 Employment of manipulative and deceptive devices.**

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,  
in connection with the purchase or sale of any security.



# List of Abbreviations

<b>ABS</b>	asset-backed securitisation
<b>ANZ</b>	Australian and New Zealand Banking Group
<b>CAT bond</b>	catastrophe bond
<b>CBOT</b>	Chicago Board of Trade
<b>CDO</b>	collateralised debt obligation
<b>CDS</b>	credit default swap
<b>CEA</b>	Commodity Exchange Act
<b>CFD</b>	contract for differences
<b>CFMA</b>	Commodity Futures Modernization Act
<b>CFTC</b>	Commodity Futures Trading Commission
<b>CIF</b>	cost, insurance, and freight
<b>CIS</b>	Collective Investment Scheme
<b>CJA 1993</b>	Criminal Justice Act 1993
<b>CME</b>	Chicago Mercantile Exchange
<b>COB</b>	California Oregon Border
<b>DJIA</b>	Dow Jones Industrial Average
<b>EDSP</b>	exchange delivery settlement price
<b>EFET</b>	European Federation of Energy Trader

<b>EFP</b>	exchange-for-physical
<b>EFS</b>	exchange-for-swap
<b>EU</b>	European Union
<b>FBE</b>	Banking Federation of the European Union
<b>FCM</b>	futures commission merchant
<b>FOA</b>	The Futures and Options Association
<b>FOB</b>	free on board
<b>FOSFA</b>	Federation of Oils, Seeds, and Fats Associations
<b>FSA</b>	Financial Services Authority
<b>FSMA 2000</b>	Financial Services and Markets Act 2000
<b>FTSE 100 Index</b>	Financial Times Stock Exchange 100 index
<b>GAFTA</b>	Grain & Feed Trade Association
<b>GMPA</b>	Global Master Repurchase Agreement
<b>HTA</b>	Hedge-to-arrive
<b>IATA</b>	International Air Transport Association
<b>ICE</b>	IntercontinentalExchange
<b>IPE</b>	International Petroleum Exchange
<b>ISDA</b>	International Swaps and Derivatives Association
<b>L/C</b>	Letter of Credit
<b>LCH</b>	London Clearing House
<b>LIBOR</b>	London Interbank Offered Rate
<b>LIFFE</b>	London International Financial Futures Exchange
<b>LME</b>	London Metal Exchange



<b>LSE</b>	London Stock Exchange
<b>NASD</b>	National Association of Securities Dealers
<b>NASDAQ</b>	National Association of Securities Dealers Automated Quotations
<b>NFA</b>	National Futures Association
<b>NYMEX</b>	New York Mercantile Exchange
<b>NYSE</b>	New York Stock Exchange
<b>OTC</b>	over-the-counter
<b>P&amp;G</b>	Procter & Gamble
<b>RAO 2001</b>	Financial Services and Markets Act 2000 (Regulated Activities) Order 2001
<b>SEC</b>	Securities and Exchange Commission
<b>SPV</b>	special purpose vehicle
<b>TBMA/ISMA</b>	The Bond Market Association and the International Securities Market Association
<b>TSA</b>	The Securities Association
<b>UCC</b>	Uniform Commercial Code
<b>UK</b>	United Kingdom of Great Britain and Northern Ireland
<b>US</b>	United States of America
<b>USD</b>	United States Dollar
<b>WTI</b>	West Texas Intermediate oil

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