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Dialogic regulation for OTC derivatives in Dodd-Frank: a suggested legal principle.

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I Introduction

The purpose of this paper is to consider whether the regulatory measures on over the counter (OTC) derivatives under Article VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (Dodd-Frank), introduced in the United States of America are able to address the problems posed by the said OTC derivatives instruments. The financial instruments engineered by OTC derivatives prior to the financial crisis of 2008 were and are still widely deployed for the purported purpose of hedging against risk. Examples of such risks are: fluctuation in currency rates or commodity prices or default risk in loans payment. However, such financial instruments are also employed for speculation on the fluctuation of the currency rates or the commodity prices or any other indices in the financial market. Its purpose is for higher financial yield. It is this latter aspect of the trade that OTC derivatives are more popular than exchange traded (ET) derivatives because the former is not subjected to regulatory control. They are therefore more flexible and tailored to the needs of the customers. And the costs of entering into OTC derivatives are less than ET derivatives because the latter are subjected to administrative and margins costs imposed by the exchanges. The popularity of the OTC derivatives market with the investors and speculators coupled with increasing new financial products - embedded with OTC derivatives elements, resulted in OTC derivatives to be traded at a phenomenally high level at the time of the crisis. According to Bruce Carruthers¹, in the United States, in 1986 the total value of ET derivatives was more than OTC derivatives. By 2008 the total value of OTC derivatives had become ten times greater than the ET derivatives even though the latter had increased by one hundred fold. Lynn Stout² provided the numbers in the growth of OTC derivatives as follows: according to the Bank for International Settlements, at the end of 1999 the total notional value of OTC derivatives was approximately US\$88 trillion. By 2008 the OTC market value had a value of about US\$600 trillion. Major financial institutions and banks held a disproportionate amount of such instruments and their value could not be determined. They became a liability as opposed to instruments which provide insurance to risk. These factors which relate to the excesses of the trade, amongst others, brought about a systematic risk to the financial market.

Little wonder at the G20 leaders meeting in 2009 at Pittsburgh, United States, they pointed to the excesses in the financial market which led to the crisis and identified OTC derivatives market for regulation: ³

¹ Bruce G Carruthers, "Diverging derivatives: Law, governance and modern financial markets" (2013) 41 *Journal of Comparative Economics* 386- 400.

² Lynn A Stout "Derivatives and the Legal Origin of the 2008 Credit Crisis" (2011) *Harvard Business Law Review* Vol 1, at 22-23.

³ Leaders Statement: The Pittsburgh Summit (September 24-25, 2009) Google Search statement_20090826_en_2.

16. *To make sure our regulatory system for banks and other financial firms reins in the excesses that led to the crisis.* Where reckless behavior and a lack of responsibility led to crisis, we will not allow a return to banking as usual.

17. We committed to act together to raise capital standards, to implement strong international compensation standards aimed at ending practices that lead to excessive risk-taking, to improve the over-the-counter derivatives market and to create more powerful tools to hold large global firms to account for the risks they take. Standards for large global financial firms should be commensurate with the cost of their failure. For all these reforms, we have set for ourselves strict and precise timetables.

Article VII of the Dodd-Frank was introduced in the United States of America in response to the G20 Leaders meeting in 2009. This paper considers Dodd-Frank as providing the blueprint of the regulations on this subject. European legislation on this issue adopts the regulatory approach of Dodd-Frank, and Singapore is in the process of putting in place regulatory measures similar to Dodd-Frank.

The question is whether the regulations under Dodd-Frank are able to address the various issues posed by OTC derivatives.

My thesis is that the regulatory measures of Dodd-Frank are not able to address the problem of excesses in OTC derivatives because (a) they do not express a clearly principled view about speculation for profit and (b) the regulatory measures do not engage the manufacturers and dealers of OTC derivatives in the regulatory process. The way to regulate OTC derivatives is to provide for a “dialogic regulation”⁴ process involving three parties: the dealers, regulators and the investors, as suggested by Dan Awrey. Such a process requires a regulatory principle on OTC derivatives be identified and articulated. It is suggested an appropriate principle is: OTC derivatives employed for the predominant purpose of speculation for profit be considered unlawful. Such a principle also serves as a criterion for the regulators in their tasks, particularly in determining whether a non-banking entity is qualified for exemptions from clearings on the ground of hedging as opposed to speculation. Furthermore, the principle is flexible enough to permit an element of speculation in hedging; much depends whether it is the substance of the transaction or a subordinate element of the transaction as formulated by Hobhouse J in the English case of *Morgan Grenfell v Welwyn*⁵. Finally, it is the thesis that such a principle might not be so easily subjected to amendment by politicians because to do so amounts to declaring publicly their own ethical position on wagering.

The methodology employed to prove the thesis is as follows:

⁴ Dan Awrey “Regulating Financial Innovation: A more principles-based proposal?” (2010-2011) 5 Brook J. Corp. Fin. & Com L 273

⁵ *Morgan Grenfell & Co Ltd v Welwyn Hatfield District Council* [1995] 1 All ER 1 at 9 Lexis Nexis. See also *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 per Hamblen J at [389].

- Firstly, it will demonstrate that OTC derivatives are problematic to the financial market on two grounds, namely (a) they are complex and opaque financial instruments and therefore a source of informational asymmetries, and (b) they have been employed for speculation for profit which accounts for the excesses in OTC derivatives trading as described by Dan Awrey.
- Next, it will demonstrate that Dodd-Frank has put in place the structure for more transparency and control on the capital and margin for the trade. The centre-piece of the structure is the clearing houses for derivatives. The clearing houses and the exchanges (for ET derivatives) become the primary places for reporting (together with the repositories) and controlling of credit risks. But they have not provided the criterion for the regulators to perform their tasks especially in determining whether the derivatives are employed for hedging or speculation. More importantly, the existing measures fail to address the issue that in OTC derivatives there will always be an imbalance of information between the creators of the OTC derivatives on the one hand and the regulators and investors on the other.
- It is suggested that in the regulatory measures we need to adopt an approach which engages the regulated manufacturers and dealers, and incentivises them to cooperate in the regulation. Such a regulatory approach is known as “dialogic regulations” as proposed by Dan Awrey. The essential precondition to such an approach is the need to state a regulatory principle of engagement.
- It is proposed that such a principle be: OTC derivatives employed for the predominant purpose of speculation for profit be considered unlawful. The principle is implicit in the regulatory measures and it is the common law rule against contract for differences. Furthermore, the principle is consonant with the United States legislative history which is premised on the principle of anti- speculation.
- Finally, the paper will consider whether regulation of speculation is futile. The legislative history on anti-speculation in the United States as outlined by Lynn Stout has shown that it has been subjected to amendment by the public and the politicians. She has therefore suggested that it is a matter best left to independent agencies like the courts for instance, to exercise legal constraints on such an activity.

In this paper, no reference will be made to the New Zealand’s regulatory measures in response to the financial crisis of 2008. The financial crisis of the type caused by the excesses in OTC derivatives was not the experience of New Zealand financial market. The Financial Markets Conduct Act of 2013 (FMC Act) in New Zealand addresses different issues. Indeed the principle objective of the FMC Act is to facilitate capital market activity in order to help businesses to grow⁶. The concern of the lawmakers is not excesses of trading in derivatives but the lack of such trading in New Zealand.

II OTC derivatives

⁶ Financial Market Authority, “A Guide to the Financial Markets Conduct Act 2013 Reforms” (November 2013).

A *What are they?*

Derivatives are a “collective term”⁷ of the financial assets developed in the 1980s and 1990s. Their value is derived from another asset, rate, index or event. The underlying connection is illustrated by Hudson as follows:⁸

So, for example, an option to buy a share at some point in the future is a financial product the value of which is derived from an underlying share. Similarly, a swap of an interest rate is a product derived from the underlying loan whose rate of interest the borrower wishes to swap: the value of the swap is derived from the extent to which it exceeds or falls short of the interest rate on that underlying loan. Hence the term “derivative” encapsulates the notion of derived value. The derivative, however, exists as distinct chose in action itself.

“All derivatives are engineered from two basic building blocks: options and forwards.”⁹ Options and forwards are contractual arrangements for sale and purchase of commodity to be realised in the future. Options provide for a right upon a contingent event in the future to dispose of an asset at a predetermined price. Forwards provide for an obligation to do so. These two building blocks could be combined in different ways to produce different types of derivative instrument.

As mentioned in the Introduction, there are two groups of derivatives: one group is traded on organised order-driven exchanges and the other, between parties over the counter. ET derivatives are standardised instruments which offer limited range of menu of the underlying and a narrow range of settlement amounts, maturity dates and strike process. The standardisation enables the exchanges to clear and settle trades through clearing houses.¹⁰

OTC derivatives are by definition derivatives traded outside the organised exchanges. In contrast to ET derivatives, they offer to the parties a financial instrument which totally bespoke their commercial needs. As such, they are more flexible and complex.

B. *Purpose*

The numerous innovative financial instruments under OTC derivatives are employed broadly for management of assets and liabilities, hedge against market risks or lowering of funds costs; and also for “enhancing yield”.¹¹

How they function could be illustrated by two species of OTC derivatives – the swap and the credit default swap (CDS). In the swap, two parties agree, at different periods to exchange their cash flows of their financial obligations on predetermined dates over a period of time.

⁷ Alastair Hudson *The Law on Financial Derivatives* (5th ed, Sweet & Maxwell, London, 2015), at 1-06.

⁸ Hudson, at 1-06.

⁹ John Armour, Dan Awrey, Paul Davies, Luca Enriques, Jeffrey N Gordon, Colin Mayer and Jennifer Payne, *Principles of Financial Regulation* (OUP, Oxford, 2016) at 21.4.1

¹⁰ John Armour and others, above n 9, at 467

¹¹ Alan Rechtschaffen *Capital Markets, Derivatives and the Law: Evolution After Crisis* (2nd ed, OUP, Oxford, 2014) at 64.

For instance, in a plain interest rate swap, a borrower of a loan at a fixed interest rate arranges with the lender to swap its obligations on fixed interest rate payment for a variable interest rate obligation. In the event of an increase in interest rate, the borrower stands to benefit from the swap. But if there is a decline in interest rate, the lender benefits from the swap.

The question is: what is the purpose of the interest rate swap? It could be lowering of funding costs. It could also be for speculation for profits. The speculative element lies in the parties' bet on the rise and fall of the interest rate. A good example of an interest rate swap is the *Hazell*¹² case. The case illustrates the ambiguity of its purposes which could be a problem. In the case, a local authority which has borrowed funds at a favourable fixed rate entered into a series of interest rate swap transactions with a bank. Its purported purpose was to lower its costs of funding by means of an interest rate swap transaction that it might profit from a rise in interest rate. The Court held that such financial transactions with the bank were ultra vires the constitution of the local authority because the objective of the arrangements was not financial management as permitted under its constitution but speculation for profit.

Another sub species of the swap is the CDS¹³. The arrangement is that the default risk of an obligation of repayment, like a loan payment for example, be transferred to another party which assumes that risk of default on payment for a fee. The benefits to the transfer of the risk to the parties are mutual: the party which transfers the risk has reduced its risk exposure and for the counterparty that assumes the risk, the arrangement is a means to "earn income and diversify its investment portfolios."¹⁴ CDS has been the main cause of the implosion of the insurance company, AIG, in the financial crisis because of the high volume of CDS held to give an impression of "insurance" for the housing loans.¹⁵ The other issue with CDS is that it is capable of being repackaged to form portfolios of assets for a new type of investment to investors. As the risk becomes more disconnected from the risk of the underlying assets, the valuation of the risk becomes correspondingly difficult to ascertain. It is susceptible to a loss of confidence of the true value of the financial instruments, as was the case in the financial crisis. A good example of such complexity is the collateralized debt obligations (CDO). They are an asset pool of numerous debt obligations, such as CDS for instance, which are held by a special purpose entity formed for the purpose of repackaging them as a financial product. Interests in the asset pools are divided and sold at different tranches based on differences in the credit quality of the assets in the pool. But detailed information about the assets pools is vague and the purchases of such interests would not be able to assess the nature or the scale of the risk exposure.

C. *Risk of OTC derivatives*

¹² *Hazell v Hammersmith and Fulham London Borough Council* [1992] 1 AC 1.

¹³ *John Armour and others*, at 468.

¹⁴ *Alan Rechtschaffen*, at 172.

¹⁵ *Alan Rechtschaffen*, at 172.

The major risk posed by OTC derivatives is the complexity and the opaqueness of the product. It is complex because of the high level of mathematics being employed to evaluate the risk. A good illustration of a mathematical formula that has been formulated for such a purpose is found in the *Dharmala*¹⁶ case. In that case the arrangement was to hedge against US dollars by employing a derivative instrument that involved calculation of the London Inter-bank Offered Rate (LIBOR) using a mathematical formula “N.” The derivatives transactions were referred to as swap1, swap2 and the amended swap 2. This part of the paper will only describe swap1. The transaction was “time dependent” in nature, based on the nominal amount of US\$50 million for a period of 2 years. One part of the transaction the investor was to pay interest rate in each year at six month LIBOR rate while the bank was to pay the same rate plus 1.25 per cent for the same period of time, thus giving the investor a 1.25 per cent margin per year. The other part of the transaction the investor was to pay at 5 per cent per annum while the bank was to pay 5 per cent per annum multiplied by “N” over 183. “N” was the actual number of days in a six month period commencing from 5 August 1994, during which the LIBOR rate was less than 4.125 per cent up to 183. If the LIBOR rate exceeded 4.125 per cent, the investor received no interest and would suffer a loss of 5 per cent per annum under this part of the transaction. In the end, the net loss to Dharmala of the two parts together came to 3.75 per cent per annum on the US\$50 million in each of the two years.

The other aspect of the complexity of OTC derivatives is that the products are engineered from the underlying assets and other financial instruments. The whole arrangement is complex and information of the interconnection is not available. The end users do not know the nature or the scale of the exposure of the risk. An example of this is the CDO described above. The lack of information in OTC derivatives is summed up by Dan Awrey as “extraordinary.”¹⁷

In view of the above, investors often found themselves at the wrong side of the bargain. The English judges in OTC derivatives cases have made the same observation that investors often do not comprehend the risk and as a result are not prepared to accept the loss. For instance, Mance J in the *Dharmala* case made this observation:¹⁸

“The financial risks involved in such transactions are not readily quantifiable on any conventional basis. There are computer programs designed to assist the banks and others who market such transactions to assess and lay off such risks. These programs are not generally available to purchasers of such products. Customers surprised by adverse market movement may, as a result of a leveraged formula, face escalating financial loss which, once at least it has materialised, they find that they cannot, or are not prepared to accept.”

¹⁶ *Bankers Trust International Plc v Dharmala Skti Sejahtera* [1995] QBD 1 Lexis Nexis

¹⁷ Dan Awrey, “The dynamics of OTC derivatives regulation: bridging the public-private divide” (2010) EBOR 11 (2) at 4.2.1.

¹⁸ *Dharmala*, at 4 Lexis Nexis

In addition to informational asymmetries, Dan Awrey also pointed to other features of OTC derivatives which posed a risk to the stability to the market: “overinvestment”, “excess of leverage” and “systemic risk”.¹⁹ At the heart of his analysis is that OTC derivatives are an inexpensive means of access to the various indices of the market in commodity, equity and interest rate. As a result there is overinvestment and excesses of leverage. Moreover OTC derivatives are interconnected to other financial product and so their influence is widespread. As Alan Rechtschaffen observed, many forward instruments even though they are not labelled as derivatives are embedded with derivatives for the purpose of obtaining high yield. He cited the case of oil contracts which provides for its delivery at a fixed price on a future date. Such contract would normally be embedded with a derivative arrangement classified as “option”²⁰. The “fundamental premise” of such financial instruments to generate more profits is accompanied by risk, and the risk and reward are inversely proportional.²¹ That is to say, the higher the reward is expected of the financial instrument, the higher is the risk exposure being included to it.

D Speculation in OTC derivatives is betting?

The question which is not asked in the above analysis is: how does one characterise the financial instruments being used “aggressively” to enhance yield²² or “highly leveraged speculation”²³ in OTC derivatives? Notwithstanding the regulatory measures of Dodd-Frank and the informational asymmetries, the volume traded in OTC derivatives remains phenomenally high even today. In 2014, according to the figures of the Bank of International Settlements, the notional value of OTC derivatives traded worldwide is US\$630 trillion compared to ET derivatives of US\$65 trillion.²⁴

Lynn Stout in her analyses on speculation in OTC derivatives separates and identifies an element of speculation which has no rational basis and has nothing to do with allocation of resources or price discovery. She distinguishes three types of speculation in derivatives. It is generally accepted that two types of speculations are of economic benefits: they allocate resources to the party which has the resources and they provide for price discovery because of greater research to the study of the price of commodity. Lynn Stout attributes the two economic benefits to the “risk hedging model” and “the information arbitrage model” respectively. The reasons for the economic benefits based on the models are self-evident: in the risk hedging model one of the parties in the transaction has more financial capacity for risk than the other in their speculation of future prices. As a result it provides financial resources for the allocation of risk. In the information arbitrage model, one party has invested more in obtaining information than the other on the commodity. As a result the price of the commodity is speculated at its true value. But Lynn Stout suggests a third model which is essentially about two parties taking very different view of future prices for no other reason than their personal preferences. She called the model “heterogeneous

¹⁹ Dan Awrey, above n 17, at 4.2.2 – 4.2.4.

²⁰ Alan Rechtschaffen, above n 11, at 71.

²¹ Alan Rechtschaffen, at 64-65.

²² Alan Rechtschaffen, at 67.

²³ Dan Awrey, above n 17, at 4.2.3.

²⁴ Arshadur Rahman, “Over the Counter (OTC) Derivatives, Central Clearing and Financial Stability” (2013) Quarterly Bulletin, at 284.

expectations (HE) model". Recently in an article published in 2011 she renamed the (HE) model as the "disagreement- based speculation."²⁵ The key features of the HE model which distinguish it from the other models are:²⁶

- The parties' perception of the future prices differs markedly, based on intuitive "differential beliefs." The difference of perception of the parties in future prices in the other two models is based on the degree of risk one party is capable of taking (the risk hedging model) and the degree of information one party has over the other (information arbitrage model). In the HE model the expectation of the speculating parties are based on what they perceived subjectively and intuitively.
- In the HE model the two parties are speculators with no interest in the commodity save for its price. It is essentially "speculator-with- speculator trading". In the other two models, the parties are interested in the commodity and one of the parties is either buying or selling the commodity.
- In the HE model the ex post loss position for the parties is one party wins and the other loses. The winning party's gain is mirrored by the other party's loss. Not so for the other models. Both parties benefit from the speculations albeit one party gains more than the other.

Clearly the critical factor of her comparison of the HE models with the other two models is the latter involves a genuine interest in the delivery of the shares or commodity, not just an interest in the fluctuation of the prices.

For those reasons, Lynn Stout considers the true nature of OTC derivatives is that they are bets:²⁷

However the true nature of derivative is best captured by the short, simple word "bets". This is not metaphor or hyperbole. Derivatives are *literally* bets – contractual agreements between the parties that one will pay the other an amount of money determined by whether or not some future event occurs. This is exactly why derivatives are called "derivatives." The value of a derivative agreement is derived from the future behaviour of some "underlying" market phenomena (market prices, interest rates, credit ratings)..

Betting or wagering is a legitimate characterisation for the aggressive trading or highly leveraged speculation because the elements of OTC derivatives transaction manifest the same elements in wagering. The elements of wagering are: future uncertain event, one party loses and the other wins, the arrangement is between two parties, and there is no interest in the uncertain event.²⁸ If that is correct, then OTC derivatives trading have wide social and economic implications. As suggested by Lynn Stout in her articles such derivatives trading creates new risk in the market without compensation and add nothing to the real

²⁵ Lynn Stout "Risk, Speculation and OTC Derivatives" An Inaugural Essay for Convivium"(2011) Vol 1: Iss.1 Article 2 at 8.["Risk, Speculation"]

²⁶ Lynn Stout "Why the Law Hates Speculators: Regulations and Private Orderings and Market OTC Derivatives"(1998-1999) 48 Duke Law Journal at 741-745. ["Why the Law Hates Speculators"]

²⁷ Lynn Stout, "Uncertainty, Dangerous Optimism and Speculations: An Inquiry into Some Limits of Democratic Governance"(2012) 97 Cornell L Rev at 1184-1185.["Uncertainty, Dangerous Optimism"]

²⁸ HG Beale (ed) Chitty on Contracts (30th ed, Sweet & Maxwell, London 2008) vol2 at [1193] to [1194].

economy.²⁹Lynn Stout's suggestions on regulation of OTC derivatives following from the above analyses will be discussed in the later section of the paper.

The characterising of the highly leveraged speculation as "betting" matters, if those exacerbating factors in OTC derivative are to be taken seriously. Dan Awrey in his paper refers to exacerbating factors due to the "impropriety of market participants."³⁰ Alan Rechtschaffen has expressed the same concerns, describing such activities as "aggressive" and "misused" which could cause dramatic risk.³¹But he does not identify what are those actions which he considers as aggressive use of financial instruments or misuse of financial instruments. For Dan Awrey the impropriety factors are insider trading, fraud and market manipulation. But they do not explain the high volume of OTC derivatives trade caused by "highly leveraged speculation" or "excess of leverage" which are of fundamental concern for him. At best they account for the occasional incidents of high trading. So their connection to highly leveraged speculation is not so obvious. But Lynn Stout's view that such speculation is wagering or betting provides a more cogent explanation of the exacerbating factors.

III Regulation of OTC derivatives

A Dodd-Frank

Dodd-Frank and Regulation (EU) No.648/2012 of European Market Infrastructure Regulation 2012 (EMIR) are the major regulatory measures which explicitly address the problems of OTC derivatives. The focus will be on Dodd-Frank because the regulatory measures of EMIR, save for minor detail differences, followed and mirrored the approach of Dodd-Frank.³² The other financial centre which is influenced by Dodd- Frank is Singapore. In 2013, the regulatory authority of United States appointed the Singapore Exchange (SGX) as its first Asian clearing house. The financial authority in Singapore is currently in the process of introducing regulatory measures for OTC derivatives similar to Dodd-Frank.³³ The recommendations of its Financial Stability Board are:

- Standardise derivatives contracts.
- Mandate central clearing of all standardised contracts.
- Move OTC contracts trading to platforms where appropriate.
- Mandate trade reporting.

They clearly are the main components of Dodd-Frank.

²⁹ Risk, Speculation at 9-10; Uncertainty, Dangerous Optimism at 1189-1193.

³⁰ Dan Awrey , above n 17, at 4.2.

³¹ Alan Rechtschaffen, above n 11, at 67, 72.

³² Stefano Pagliari "Public Saliency and International Financial Regulation. Explaining the International Regulation of OTC Derivatives, Rating Agencies, and Hedge Funds" (PhD thesis, University of Waterloo , Canada, 2013) at 164-165.

³³ Stephanie Magnus and Ying Yi Liew "Regulating OTC Derivatives in the Little Red Dot: A snapshot of Developments in Singapore" (2016) 36 No.2 Futures and Derivatives L Rep NL 2.

In view of the fact that Dodd-Frank is the blueprint of the regulatory measure for OTC derivatives on the topic, it is not necessary to compare it with the regulations of EMIR or the provisional regulatory measures of Singapore.

The approach of Dodd-Frank to OTC regulation is as stated by the lawmaker - Senator Chris Dodd himself:³⁴

[O]ver-the-counter derivatives will be regulated by the SEC and the CFTC, more transactions will be required to clear through central clearing houses and traded on exchanges, un-cleared swaps will be subject to margin requirements, swaps dealers and major swap participants will be subject to capital requirements and all trades will be reported so that regulators can monitor risks in this vast, complex market.

Broadly the strategy of Dodd –Frank is two- fold: (a) increased transparency in derivatives trade and (b) reduced counterparty risk and systemic risk.³⁵The increased transparency would be achieved by the following regulatory requirements:

- Keeping a record of the dealers and major participants in swap and security- based swap. They are required to be registered with the CFTC³⁶ and SEC³⁷ respectively.
- Keeping a record of all ET and OTC transactions. They are required to be reported to trade repositories (called “swap data repositories” in Dodd-Frank)³⁸. The trade repositories as well as the clearing houses are required to publish the trading data.

Counterparty risk and systemic risk would be reduced by the following regulatory requirements:

- By imposing minimum capital and margin requirements for both ET and OTC derivatives on the trade and the dealers and participants.³⁹
- By mandating that ET derivatives have to be settled by clearing houses and traded through exchanges. However the way the provisions are worded they compel all derivatives to be submitted for scrutiny by the clearing houses whether they are required for clearings or not.⁴⁰

However, there is one significant exemption, namely that a non- financial entity which employed derivatives for hedging or mitigating commercial risk is exempted from clearings.⁴¹

B Weakness in Dodd-Frank

³⁴ Cited by Alan Rechtschaffen , above n 11, at 218.

³⁵ Alan Rechtschaffen, above at 227.

³⁶ Commodity Future Trading Commission.

³⁷ Securities and Exchange Commission.

³⁸ Ss 727, 729 and 766 of Dodd-Frank..

³⁹ Ss 731 and 764 of Dodd-Frank.

⁴⁰ Ss 723(a) (3) and 763(a) of Dodd-Frank.

⁴¹ Ss723, 763 of Dodd-Frank.

The main weakness of Dodd- Frank is that there is no legal principle set out in its approach to OTC derivatives. As a result there is no guideline for the regulators in carrying out their tasks. The regulators under Dodd Frank have been assigned various tasks, most of which are unclear as to what is the governing principle. For instance, under s 723 of Dodd- Frank, the Commission is to initiate review of swaps of any category and class as to whether they are required for clearing houses. It has ninety days after receiving the submission to decide on the matter and the factors it has to take into account mainly relate to the issue of the scale of the exposure and its effect on the market. The factors are:

- Existence of significant notional exposures.
- Availability of credit support infrastructure to clear the contract.
- Effect on the mitigation of systemic risk.
- Effect on competition.
- Existence of reasonable legal certainty in the event of insolvency.

They are not factors which suggest a criterion about speculation that could assist the regulators to determine the purpose of any financial instruments. It is difficult to see how those five factors could assist a regulator to determine whether a financial instrument is intended for hedging or highly leveraged speculation. The objective of the five factors is about limiting the impact of the financial exposure of OTC derivatives in the market.

The Commission is also empowered to provide rules for the clearing houses and to prevent evasions of the clearing requirements. But no principled guideline is provided for the tasks.

It is for this reason that Eric Posner has criticised Dodd-Frank an empty vessel:⁴²

But the Dodd-Frank Act is an empty vessel: it authorizes agencies to regulate without giving them much guideline as to how to regulate. So numerous questions remain open as to how the agencies should use their authority, and indeed whether the Dodd-Frank Act creates the proper regulatory structure.

Whilst he agreed with Lynn Stout's approach in characterising derivatives are in essence gambling, he offers a different solution to the one suggested by her, which is to legally ban it. He suggests a guideline that is premised on insurable interest. The criterion of an insurable interest is consistent to an economic principle solution on the welfare – value principle. His solution is similar to the way the regulatory agency for pharmaceutical product approves of its products. It is beyond the scope of this paper to do a comparison of his approach to that of Lynn Stout's solution which is more consistent to her conclusion that derivatives are wagering.

The other weakness of the regulations under Dodd-Frank is its model of regulation is one which Dan Awrey describes as "optimality of rules" as opposed to principle⁴³. It is a model

⁴² See Eric A Posner & E Glen Weyl "An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to 21st Century Financial Markets" (2013) 107 North Western University Law Review 1307 at 3.

which is particularly unsuitable with OTC derivatives because of the problem of informational asymmetries of the product. The problem becomes more acute with the propensity of the product to innovation. There will always be a lag in information for the regulators. More importantly, as the product is also complex, it is doubtful whether the agencies for the clearing houses (CCP) have the capacity and incentive to monitor the trade. Dan Awrey has provided a non- exhaustive Table 1 of the technical issues involved in the tasks of the clearing houses in the calculation of minimum margins: ⁴⁴

Table 1 Major High-Level Technical Issues for CCPs
Product eligibility criteria (i.e. evaluating potential liquidity, susceptibility to manipulation, etc.)
CM eligibility criteria (i.e. evaluating financial resources, operational capacity and expertise)
Structure of the lines of defence against CM default (i.e. the capital waterfall)
Methodology for calculating initial and variation margin requirements
Methodology for valuing posted collateral/Quality of collateral requirements
Timing and method of variation margin payments
Methodology for calculating CM contributions toward any CCP guarantee fund within the capital waterfall
Emergency liquidity support/Participation by non-defaulting CMs in the event of CM default (i.e. the portability of positions) and other resolution procedures

Apart from the technicality issues, the calculation of the initial and variation margins requires sophisticated financial models which incorporate amongst other variables, historic volatility, market volatility, and any idiosyncratic characteristics of the relevant instrument. The task also requires continual monitoring of the counterparty positions. The calculation of the margin becomes more complex when the CCP engages in “portfolio margining” across all of the counterparty opening position.⁴⁵ In addition, the financial model requires rigorous and on- going testing and calibration to reflect relevant market development. The whole point of it all is that the majority of regulators are simply out of their depth in their tasks.

For the sake of completeness it should be mentioned there are other concerns of the clearinghouses as an effective means to constrain “socially excessive risk-taking” because of the following factors: firstly, that there is conflict of interest as most of the clearing agencies are owned by derivatives dealers and secondly, competition between the clearinghouses might lead to lowering of the requirements. For these reasons doubts are expressed as to whether the regulators possess the incentives to monitor and manage the risks.⁴⁶

⁴³ Dan Awrey, above n 4, at 274

⁴⁴ Dan Awrey, at 305

⁴⁵ Dan Awrey, at 306 -307

⁴⁶ John Armour and others, above n 11, at 475.

IV *Dialogic regulation*

This part of the paper considers the theory of a more principles- based regulation (MPBR) of Dan Awrey as model in regulating

The rationale for this model is the nature of the financial instruments themselves, namely, they are complex and innovative. This is particularly so with financial instruments engineered from OTC derivatives. The risk they posed to the financial market has been discussed in the previous sections of this paper. In such a situation, rules- based, prescriptive regulations are unlikely to address the problems: firstly, the regulators may not understand the complexity of the product and secondly, the regulations may be rendered irrelevant or ineffective as newly engineered products are developed and sold in the market. In short, the regulators and their regulations will always be left behind in the process.

The MPBR model which is more accurately described as a dialogic regulation proposes regulations which are formulated from constant dialogue between the regulators and the regulated actors and end users. This notion of co-operation between is pivotal to the process:⁴⁷ “MPBR is premised upon an iterative, dialogic relationship with which regulated actors (and other stakeholders) are invited to play a potentially important role within the process of generating regulation.” The philosophy behind it is not about institutional structure or regulations; “it is concerned with *who* generates that regulation and what sort of environment they generate it.”⁴⁸

The next question is what is required to bring about such a dialogic regulation? Dan Awrey proposes four essential requirements:⁴⁹

- Identification and articulation by the regulators of the outcome-orientated principles.
- Fundamental change in the philosophy of both the regulators and the regulated actors towards their respective roles.
- Fostering a new relationship between the regulators and the regulated actors based on real trust.
- Credit commitment by regulators to enforcement.

It appears that the four requirements hinge on the “outcome- oriented principles.” In other words much depends on the objective of the principles. If the objective is one which captures the aspiration of the parties, then the other elements will fall into place. It also appears that such principles are to be initiated by the regulators. The next section of the paper will propose such a principle. However, even before coming to it, what reasons could

⁴⁷ Dan Awrey, above n 4, at 284.

⁴⁸ Dan Awrey at 283.

⁴⁹ Dan Awrey, at 287.

be offered to persuade the regulated actors to come on board to such a dialogic process? What will bring about a change in attitude of the manufacturers and/or dealers of OTC derivatives to this new approach towards regulations?

It is suggested there are four good reasons for manufacturers and dealers of OTC derivatives to take the dialogic process seriously. The first is, as suggested by Dan Awrey, they will have some measure of input to the regulations⁵⁰. The regulations under this process are of two kinds: one is substantive and the other is technological. At the substantive stage, it is envisaged that they will be able to engage the regulators at the highest level in discussing the principles and their implications. Out of such discussions they are entrusted to prescribe the technological rules which will govern the trading of OTC derivatives. So the process provides them with considerable input to the regulations.

The other reason is that the process provides the makers of the markets to address the issue of trust in their trade. The perception of the public has been that the makers of the market have been selfish in pursuit of higher profits. There is increasing realisation that the makers of the market have to do their part to restore trust in their trade. In May 2013, Goldman Sachs in New York published a report “Business Standards Committee Impact Report” to state its reformed approach to the business, which is to have regard to the interest of its clients. Apparently it is also driven by reputational sensitivity and accountability to the public. The critical question is whether the exercise is one of “robust improvement or a cynical privileging of symbolism?”⁵¹ It is also interesting to note in the report, Goldman Sachs also expresses the uncertainty of regulatory reform as a consistent theme of concern for its business. The dialogic process would be the best way to address all these issues, especially trust to the business and its reputation.

The third reason is that there are a whole host of issues about the financial market which may be of concern to the regulators as a public authority which could not be ignored. The dialogic process would be a forum to consider such larger issues and for the market makers in OTC derivatives to also consider the wider consequences of their business. The preceding paragraph refers to one of the issues being restoring trust. There are others. One of the most pressing is the suitability of the OTC derivatives products themselves. There are current issues and concerns with regard to CDS and CDO. The widespread use of CDS in sovereign debt of countries like Greece and other European countries is a matter of concern. Such concerns have been expressed in various financial sources. For instance, Wolfgang Munchau, writing in the Financial Times, has called for its ban.⁵² Justin O’Brien in his chapter on Professional Obligation⁵³ referred to the Fabrice Tourre case where he was

⁵⁰ Dan Awrey, at 286-287.

⁵¹ Justin O’Brien “Professional Obligation, Ethical Awareness, and Capital Market Regulations” in Nicholas Morris and David Vines(ed) *Capital Failures: Rebuilding Trust in Financial Services* (Oxford Scholarship Online, 2014) at chap 10, p 8

⁵² Wolfgang Munchau “Time to Outlaw Naked Default Swaps” (28 February, 2010) Financial Times.

⁵³ Justin O’Brien, above n 47, at 7.

prosecuted by the Securities and Exchange Commission for regulatory violations. The most remarkable feature of the case was the open characterisation by both the prosecutors and the defence that the CDO market is speculative gamble devoid of economic benefit.⁵⁴ It is envisaged that all these public issues, would be of concern to the regulators and would compel the market makers to consider a wider societal perspective of their trade than the purely financial perspective. More importantly, the discussion would not be of mere academic interest because the discussion is set within the context of a regulatory regime. Potential regulatory measures would be very much part of the consideration. If that is so, it would be an opportunity for the regulated actors to have their say in the matter.

The fourth reason is there are areas in the Dodd-Frank which the dialogic process could assist in filling in their contents. For instance, Dan Awrey has identified three areas:⁵⁵

- The requirement that the clearing houses are to provide for sufficient financial resources to meet their obligations.
- The quantitative and qualitative elements which constitute “substantial position” for major swap participants.
- Criteria which define hedging or mitigation of commercial risks for exemptions to clearings.

There will be other areas of Dodd-Frank which require further clarifications and refinements in the course of its applications.

The last critical factor on the subject is the position of the derivatives trade group in this process: how would the International Swaps and Derivatives Association (ISDA) be placed in this process? ISDA has established for itself a powerful and effective role in the operation and private governance of the business. ISDA Master Agreements are widely used in OTC derivatives transactions and their terms have been upheld by the English courts as legitimately defining the legal contractual relationship of the parties.⁵⁶ They have been able to intervene as an interested party in major legal cases involving derivatives transactions both in the United Kingdom and the United States. They are consulted by the regulators and head of regulatory authority on the governance of derivatives trade. For instance, ISDA has developed an online portal for companies to report on the traders’ obligations for clearings in the clearing houses in United States and Europe.⁵⁷ And in November 2013 it was reported that the governor of the Bank of England, other heads of the regulatory bodies in United

⁵⁴ Justin O’Brien above n 51, at 8. See also Bray, Chad and Justin, Baer “Testimony of Laura Schwartz” Wall Street Journal (23 July 2013)

⁵⁵ Dan Awrey, above n 4 at 310-311.

⁵⁶ See *Lomas and others v JFB Firth Rixson Inc and others (international Swaps and Derivatives Association Inc, intervening) and others* [2012] EWCA Civ 419; *Belmont Park Investment Pty Ltd and others v BNY Corporate Trustee Services Ltd and anor* [2011] 3 WLR 521

⁵⁷ Alice Attwood “ISDA Markit creates clearing tool for EMIR” (8 May 2015) FO Week.

States, Germany and Switzerland have called on ISDA to amend their Master Agreements to provide for a delay in the close out positions in the credit event occurring.⁵⁸

ISDA's apparent position with regard to Dodd Frank is that the mandate for clearing is working well. Furthermore, it is in a position to "pressure" the regulators to harmonise reporting rules and rules for less onerous initial margin.⁵⁹ So the question is whether ISDA would be persuaded to participate in such a dialogic process when it could apparently exercise such authority and influence in the governance of the business outside a regulatory system.

V Principle for the dialogic regulation

The next question is: what would be an appropriate principle that could be carved out of Dodd-Frank for the dialogic regulation. The outcome of the principle has to be the following:

- That the issue of excesses in OTC trade is addressed.
- That the makers of the OTC derivatives are incentivized to the process and share their expertise.

A Characterising the excess

As mentioned in Section II above, Lynn Stout has characterised the excesses in OTC derivatives as bets. Her view is based on her analysis of the three types of speculation as discussed. The disagreement-based model identified by her as the factor to excesses in speculation is consistent with the empirical evidence about OTC derivatives trading. Firstly, after the Commodities Futures Modernisation Act in 2000 (CFMA) which had liberalised OTC derivatives, by 2008 there was a huge imbalance in the notional value of CDS of US\$67 trillion written on US\$15 trillion of bonds and asset based securities issued by the firms in the United States at that time. Such an imbalance does not suggest the economic benefit from speculation: "it seems highly questionable to assume that US\$67 trillion of CDS written on US\$15 trillion of bonds could be insurance."⁶⁰ Secondly, the OTC market produced the exact results one expected to see from purely disagreement –based trading: dramatic increase in risk unaccompanied by an evident social benefit. In the risk hedging model risks would have been shifted to the right parties which had the capacity for them. But that did not happen. We have had the 2008 financial crisis. The only explanation for it is the disagreement-based model in speculation.

Interestingly, at the time of the passage of the CFMA in 2000, gambling in United States, legal and illegal, had risen by sixtyfold since 1962.⁶¹ The prevalence of gambling has been

⁵⁸ Hazell Sheffield "FDIC Pressure ISDA To Change Master" (4 November, 2013) Derivatives Week.

⁵⁹ Cian Burke "ISDA praises Dodd-Frank implementation" (20 July, 2015) FO Week.

⁶⁰ Risk, Speculation, above n 25, at 11.

⁶¹ Robert J Shiller *Irrational Exuberance* (2nd ed Princeton University Press, Princeton, 2005) at 53.

considered a precipitating factor to the boom in the property market. If that is correct then it explains the phenomena of the financial crisis in 2008 including the surge of innovations in new financial products. It also explains regardless of the complexity of OTC derivatives it does not deter speculation of such type.

The phenomenon of speculation in the financial market has been a subject of study by Robert Shiller in the field of “behaviour finance” which he considers the central pillar of serious financial theory. His study identifies gambling as a phenomenon in speculation in the property market and its effect on financial volatility because of the irrational exuberance which gambling produced for the speculators. It is this behaviour of gambling which yields an inflated sense of good luck and performance. It also provides a simple justification in the decision of the speculators. It is based on a belief that there is sufficient research done on the subject and one could “free ride” on what has been done. So the decision of the gamblers involves “story telling” as opposed to hard analysis of the market. Robert Shiller sums up the situation as follows:⁶²

There is a basic human interest in gambling, seen in one form or another in all cultures, an interest that also expresses itself in speculative markets. Some of the attraction to gambling, despite odds that are often openly stacked against gamblers, apparently has to do with narrative-based thinking. When gamblers are heard talking they are usually telling stories, not evaluating probabilities..

Apparently such stories convey a sense of “meaning and significance” to the events which are in fact purely random.

There is therefore legitimacy in Lynn Stout’s view that OTC derivatives trade is wagering, albeit considered from a different perspective from Robert Shiller’s work.

B Principle

If Lynn Stout’s view on derivatives is wagering and it is the thesis of this paper that it is, then the principle for the dialogic regulation needs to say that speculation for profits in OTC derivatives is unlawful. That is the logical step.

1 Wisdom of the common law

The next step is to formulate a principle to that effect but is relevant to the context of Dodd-Frank. It should not be a principle that is imposed from outside the regulatory regime of Dodd-Frank. It has to be a principle that which is part of its regulatory regime and also within the tradition of the legislator history of the country on the subject. Underlying the exception and exemption provisions of Dodd-Frank is a common law principle of the United States. The common law principle is expressed in the exclusion provision to certain types of transactions: equity options, commodity futures and physically settled commodity which contemplate the delivery and/or receipt of physical commodities in connection to a business

⁶² Shiller, above at 152.

purpose. The same is expressed in the exemptions from clearings related to non-financial entity and derivatives employed for hedging and/or mitigating commercial risk. Behind these provisions is the rule that permits genuine hedging but forbids gambling. This is the common law rule against a group of contracts known as “contracts for differences”. They are transactions in stock exchange or commodity market where the sole interest lies in the trading results. They are considered by the common law courts as wagering contracts. There is however a significant exception. If the transactions involved an obligation to make or accept delivery of the commodity or facilitate a transfer of the share, then the transactions are not wagering. The classical statement of the common law position in the United States, which is regularly cited by Lynn Stout in her writings, is the Supreme Court judgement of *Irwin v Williar*:⁶³

The generally accepted doctrine in this country is...that a contract for the sale of goods to be delivered at a future day is valid, even though the seller has not got the goods, nor any other means of getting them than to go into the market and buy them; but such a contract is only valid when the parties really intend and agree that the goods are to be delivered by the seller and the price to be paid by the buyer; and, if under the guise of such a contract, the real intent be merely to speculate in the rise or fall of process, and the goods are not to be delivered, but one party is to pay to the other the difference between the contract price and the market price of the goods at the date fixed for executing the contract, then the whole transaction constitutes nothing more than a wager, and is null and void.

2 *Anti-speculation law in the United States*

Indeed, according to Lynn Stout, the whole legislative history of the United States on the regulation of the financial market is informed by concerns about excessive speculation (except for the short period after the passing of the CFMA in 2000):⁶⁴ “Antispeculation rules are pervasive, appearing in statutes and in common law in doctrines ancient and new, and at the state and federal levels.” The governing legislations prior to CFMA have been the Securities Exchange Act 1934 (SEA) and the Commodity Exchange Act 1934 (CEA). They were the legislations passed after the 1929 market crash and the ensuing Great Depression which were designed to curb excessive speculation. Section 2 of the SEA speaks of the need for regulation:⁶⁵

[T]ransactions in securities as commonly conducted upon securities and over-the-counter- markets are affected with a national public interest.... Frequently the process of securities on such exchanges and markets are susceptible to ...excessive speculation, resulting in sudden and unreasonable fluctuations in the process of securities... National emergencies ...are precipitated, intensified, and prolonged by ... sudden and unreasonable fluctuations of securities process and by excessive speculations....

⁶³ *Irwin v Williar* (1884) 110 US 499.

⁶⁴ Why the Law Hates Speculators, above n 26 at 703-704.

⁶⁵ Cited in Why the Law Hates Speculators, at 729.

Likewise the SEA required the regulators to impose rules on margin requirements and short sales restrictions be imposed by the regulators.⁶⁶ Whilst CEA and SEA have been amended, the primary purpose of the legislations remains the same which is to curb excessive speculations. This is also the apparent purpose of Dodd Frank. Therefore it is consistent to carve out of the Dodd-Frank a principle that expresses that purpose. What has been proposed is reflective of that purpose.

3. *Criterion to distinguish hedging from speculation*

The principle as proposed contains a criterion which might assist the regulators to determine whether an OTC derivatives instrument is for hedging or speculation. The criterion is to consider on the predominant purpose of the financial instruments. The criterion is formulated by Hobhouse J in the *Morgan Grenfell v Welwyn* case. The brief facts of the case are as follows: Morgan Grenfell (the Bank) and Welwyn (local authority) entered into interest rate swap. The Bank was the fixed interest rate payer and Welwyn the floating interest rate payer. At the same time Welwyn through the Bank entered into parallel contract with another local authority (Islington BC) as a fixed interest rate payer and the latter as floating interest rate payer. The terms and amount and maturity time of the two arrangements were the same. From Welwyn's point of view these contracts were wholly back-to-back.

A similar financial arrangement was entered into between a bank and another local authority which had an impact on the *Morgan Grenfell v Welwyn* case: this is the *Hazell* case which is considered above. The judgement of the House of Lords in the *Hazell* case determined that such arrangement was ultra vires the constitution of the local authority. As a result on 23 June 1989 no further payments were made by the parties and the Bank claimed against Welwyn for payment made and the latter claimed against Islington BC for the payment under the parallel contract.

In the third party proceedings Islington BC raised the following issues as preliminary points for consideration by the Court:

- Whether the contract was a wagering contract.
- If it is, is it a contract by way of business within the meaning of s 63 of the Financial Services Act?
- If the answer to the second question is negative, is there a defence based on the fact that it is a wagering contract?

Hobhouse J held that the transactions entered into by the local authorities were not wagering contracts for the following reasons:

- Based on the *Hazell* case interest rate swap contracts should not be viewed as gaming and wagering contracts. Prima facie they were "legitimate and enforceable commercial contracts."⁶⁷

⁶⁶ See *Why the Law Hates Speculators* at 729-730.

⁶⁷ *Morgan Grenfell*, at 7 LexisNexis.

- Notwithstanding the interest rate swap contract had the feature of a contract for differences, namely that it was only interested in settlement of the payment difference, it did not mean that it was a wagering contract. “It merely raises that possibility or justifies an inference. If the other features of the relevant transaction show or confirm that it is a wagering contract, then it is unenforceable and void.”⁶⁸
- The Judge then considered the purpose and effect of the swap contracts entered into by the local authorities and that their effect was to incur a revenue liability. Their purpose was not for the purpose or motive to speculate or make profits by speculating. Any such profit or loss would be coincidental to the main purpose which was to mitigate the cost of transaction: “The speculative element was involved in the transaction solely because of the contractual mechanism which Islington were using to obtain, in their revenue account, loans the later years to the first year.”⁶⁹ “If there was an element of wagering in what Islington did, it was merely a subordinate element and was not the substance of the transaction and does not affect the validity and enforceability of the transaction.”⁷⁰

It would appear that the test is: what in substance is the dominant purpose of the transaction and whether the wagering element is subordinate or co-incident? For instance, a financial arrangement was entered for the purpose of hedging against fluctuation in currency rate or oil price, and added to this purpose, was a bet on the rise and fall of currency rate or oil price. Assuming that the additional betting arrangement was complex and involved substantial financial settlement at various times, how would the test apply in such a case? The mechanic for hedging against future fluctuation of oil price or currency rate is a straightforward matter. A simple forward contract will secure the transaction. The arrangement to speculate on it for profit makes the transaction complex. The terms for such an arrangement would occupy a substantial part of the contract. In most cases it is this arrangement for speculation which is the cause of the financial loss. In such a case, can it not be considered that it is the arrangement for speculation which constitutes the substance of the transaction?

Such an approach was taken in *Titan Wheels v Royal Bank of Scotland*⁷¹ case. The case involved Titan Wheels, a manufacturer of steel wheels in Europe, and its income was predominantly in euros. Its business required it to sell euros and purchase sterling on a regular basis. It purchased currency swaps from the bank for the purported purpose to hedge against currency fluctuation.

Of relevance is David Steel J’s decision that the transaction was not entered into for the sole purpose of hedging but for speculation. The “test” he applied follows the logic of what hedging is: it should be a simple forward contract and anything more than that is for speculation. This is self-evident from the oral evidence of Mr Annetts, the Financial Controller of Titan Wheels given at cross examination:⁷²

⁶⁸ *Morgan Grenfell*, at 8 LexisNexis.

⁶⁹ *Morgan Grenfell*, at 8 LexisNexis.

⁷⁰ *Morgan Grenfell*, at 9 LexisNexis.

⁷¹ *Titan Wheels Ltd v Royal Bank of Scotland Plc* [2010] EWHC 211 (Comm) (transcript) at [51].

⁷² *Titan Wheels*, at [73]

Q Clearly you wanted to hedge the large balances of euros which you were receiving.

A Yes.

Q That was vital for risk management. But if that were your sole objective, you could've continued to do that by a simple forward.

A Yes.

.....

Q So if you go for a structured product, you must be looking for something in addition to the hedging.

A Right.

Q And that was some profit as well.

A Yes.

Q Yes. Otherwise you wouldn't have done it that way. It makes sense, doesn't it?

A Sure.

However, it could be envisaged that the two purposes – hedging and speculation - could be equally dominant. Take for instance a case like *Chartered Bank v Ceylon Petroleum*⁷³ which involved Ceylon Petroleum (CP), a Sri Lankan's state owned company which bought crude oil in the international market and imported it to the country for refining and retailing. It was exposed to volatile fluctuation in oil price from 2003 to 2008. In 2007, CP entered into oil derivative transactions with Standard Chartered Bank (the Bank). The arrangement of the derivative transactions was the Bank was required to make payments to CP when oil prices were high. On the other hand CP had to make payments to the Bank if the oil price fell below an agreed floor.

How is the test to apply in this case? The Judge in the case held CP's strategy involved a combination of concerns and considerations which differed at various times depending on the market conditions of the oil prices. However, all the hedges related to the underlying physicals and provided protection against both high and rising prices. Notwithstanding the extent of the protection became limited and CP also became increasingly interested to use the hedging more for cash flow and foreign exchange generation, price protection remained an element of its strategy and that the strategy was never "solely or predominantly driven by speculative profit making."⁷⁴

The above cases illustrate the main virtue of the principle which consists of a test based on pre-dominant purpose against speculation: it is a simple test but it is a test that requires consideration of all the relevant factors of the transaction to determine whether the transaction is designed predominantly for speculation. The advantage of this test is that it is formulated by the English courts and so there are precedents to guide the regulators. It is the application of the principle on a set of circumstances which the regulators are required to apply. It is not an exercise of judgment which requires legal skills but it does require judicious consideration of various factors. It could be envisaged that with time the regulators will be able to develop the skills for the tasks.

4 *Incentive to the regulated actors*

⁷³ *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785(Comm)

⁷⁴ *Standard Chartered*, at [389].

The incentive in the principle lies in the legal sanction against the activity – employing OTC derivatives predominantly for speculation is unlawful. Its formulation and effect are the same as the provision in s 723(a) (3) of Dodd-Frank which requires derivatives to be submitted for clearings: “..it shall be unlawful for any persons to engage in a swap unless that person submits such swap for clearing to a derivative clearing organisation....if the swap is required to be cleared.” Worded in this way it compels all derivatives to be submitted for consideration by the regulators. The same response is produced should the principle against excessive speculation in OTC derivatives is worded as “it shall be unlawful for OTC derivatives being employed predominantly for speculation for profit.” In other words, because of the legal sanction, the manufacturers and dealers of OTC derivatives might be compelled to satisfy the regulators and other market participants that their products are not designed for the purpose of speculation for profit. The initiative in the dialogic process of the regulation, with such a principle, would be for the makers of the market to justify the purpose of their financial product.

VI Limits to regulating speculation in OTC derivatives.

Lynn Stout’s solution to regulation of OTC derivatives is unclear. In 2009 her view was that they were best left to private governance by the market actors and participants. No public resources be wasted on regulating such a market. Since the passing of the Dodd Frank, it is not clear whether she is still of the same view. But she is consistent with the view that regulation of the OTC derivatives is best left to other independent agencies as opposed to democratic institutions.

She is sceptical of democratic governance of this issue as a matter of principle simply because it is subject to “democratic pressures” of the politicians and market players and participants. The democratic process is ill suited to govern such fervour for optimistic speculation. Economic uncertainty plus the “animal spirits”⁷⁵ of speculation will continue to fuel gambling and it is a matter of time the detrimental effect of gambling or the excesses of the financial crisis of 2008 will be forgotten.⁷⁶ It is a matter of time the politicians and the market players will dismantle any regulations on gambling and those parts of the Dodd-Frank which forbid such activity.

There is evidence for Lynn Stout’s scepticism: she refers to her analysis of the legislative history of the United States which is premised on the country’s concerns for speculation since the market crisis in 1929 based on the common law wisdom against gambling which was radically changed with the passing of the CFMA in 2000. This has been discussed on page 18 of this paper. Her own assessment of Dodd-Frank appears to be that lawmakers have not recovered the same ethical or moral standard on gambling. The exemption provisions for clearing requirements to hedging or mitigation to commercial risk is a concession to the “animal spirited” speculators.

Another clear illustration could be taken from the English situation. Prior to the Financial Services Act of 1986 (FSA), financial instruments were subject to s 18 of the Gaming Act 1845. The provision in that statute would render all contracts and agreements by way of

⁷⁵ Uncertainty, Dangerous Optimism, above n 27, at 1211.

⁷⁶ Uncertainty, Dangerous Optimism, at 1195 -1198.

gaming or wagering null and void: no action for recovery of money or valuable thing under such contract could be maintained in a court of law. The situation that led to the FSA is the sort of situation which Lynn Stout is concerned about. The Thatcher Government and the market players in their optimism about all things financial ensured that anti-speculation legislation like s 18 of the Gaming Act should not stand in the way of financial innovations. There was optimistic exuberance for deregulation of financial speculation in the financial market at that time.⁷⁷ The expectation of the lawmakers on derivatives was that there should not be any legal uncertainty on financial products: “The lawmakers thus seemed to be on the same side as the fast burgeoning derivatives market. It did not seem likely that legal technicalities would be allowed to stand in the way of its growth.”⁷⁸As a result two parts of the FSA were enacted to remove the effect of s 18 of the Gaming Act 1845:

- Section 63 of FSA provides as follows:

‘(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...

(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 either party constitutes an activity which falls within paragraph 12 Schedule 1 of this Act or would do so apart from Parts III and IV of that Schedule.’

- Paragraph 33 of Schedule 1 of FSA states: “In determining for the purposes of this Schedule whether anything constitutes an investment or the carrying on of investment business section 18 of the Gaming Act....shall be disregarded.”

To date even with the aftermath of the financial crisis in 2008, the substance of s 63 of the FSA remains and survives the legislative amendments of the FSA.

Her solution appears to reside in other independent agencies: ⁷⁹

...when it comes to regulating optimism-driven speculation, we would do better to rely instead on relatively non democratic governing institutions and authorities, such as an independent judiciary, independent agencies and even private self-regulatory bodies.

The role of the judiciary on this issue has considerable merits because of their experience and wisdom in this issue. For instance, the English judges adopt a benign approach to speculation, which is evident from the case to be considered in a moment. Furthermore, they are faced with a legislation which expressly approved of contractual arrangement designed for speculation. Even in such circumstances, the English judiciary remains sensitive and alert to the issue of gambling and its consequences on society. This is evident in the case of *City Index v Leslie*.⁸⁰ The judges in the Court of Appeal were faced with a betting

⁷⁷ Roger McCormick *Legal Risk in the Financial Markets* (2nd ed, Oxford University Press, Oxford, 2010), at 14.27

⁷⁸ Roger, above, at 14.27.

⁷⁹ Uncertainty, Dangerous Optimism, above n 27, at 1199

⁸⁰ *City Index Ltd v Leslie* [1991] CA (Civil Division) 1, [1991] 3 All ER 180.

contract, which is a fact not in dispute. There is no issue on this fact. The issues of the case are as follows:

- City Index was a member of the Association of Futures Brokers and Dealers and ‘authorised persons’ under the FSA as well as being licenced bookmakers. Leslie applied to City Index for credit betting facilities and entered into index betting, that is betting on the movements of the various indices except sports.
- At the end of 1988 he was indebted to City Index to the amount of 34,580 pound and the latter sued for the sum. The loss he suffered was bets on Dow Jones Index and the price of Treasury Bonds.
- Leslie in his defence raised the issue that the transaction was wagering and therefore City Index’s claim was unenforceable by virtue of the Gaming Acts of 1845 and 1892 which in turn raised the application of s 63 of the FSA which disapplied the effect of the Gaming Acts.

The Judges held that the betting transaction came within the ambit of s 63 of the FSA for two reasons: firstly, City Index was a party within the meaning of s 63 (2) of the FSA. Secondly, the betting transaction was an “activity” within the meaning set out under paragraph 12 of Schedule 1 being: “Buying, selling, subscribing for or underwriting investments or offering or agreeing to do so, either as principal or as an agent”. The word “investments” in turn referred to s 1 of FSA which definition referred further to Part 1 of Schedule 1. Paragraph 9 of Part 1 of Schedule 1 states:

Rights under a contract for differences or under any other contract the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in the value or price of property of any description or in an index or other factor designated for that purpose in the contract.

The judges found the expression “pretended purpose” odd and could not comprehend the purpose behind those words. As a result they expressed different views on how the betting transaction in this case fell within the provisions. Lord Justices Donaldson MR and McCowan LJ thought it came within “any other contract” but Lord Leggatt LJ took the view that it was a contract for differences⁸¹.

Of relevance to this paper is the Judges’ view of the betting contract. Lord Justice Donaldson provided a useful background description of the financial markets for derivatives. His Lordship’s analysis points to the duality of the purposes and the consequences of the differing purposes:⁸²

The markets exist to reconcile the apparently irreconcilable needs of these two groups, the producer of the commodity and the user of it. It can do this in a number of ways, but in essence those who operate in the markets back their judgement of how the price will move between the moment when the user needs to achieve certainty as to his costs and the moment when the producer is willing to enter into firm contracts to supply....From contracts for differences it is but a short step to contracts based upon the movement of price indices

⁸¹ *City Index*, above n 81, at 7 LexisNexis.

⁸² *City Index*, at 5 LexisNexis.

which achieve the same basic objective. Clearly this system would not work if all dealers in the market took the same view as to future movements in price and equally clearly the more people there are dealing in the market, the greater the opportunity for a diversity of view. So it comes about that the intervention of 'speculators' from outside the market is not wholly unwelcome and indeed may in some circumstances contribute towards the achievement of the real objective of the market, although in some circumstances they can unsettle a market in no one's interests other than their own.

On the whole, his Lordship takes a benign view towards the ambiguity of the purpose in financial transaction and speculation. It appears it is not a matter which the courts need to resolve. At the same time the courts are alive to the social harm it could cause.

However, his Lordship did express concerns about such betting transaction on young people like Leslie in this case. He was 21 years old. He suggested a limit to the amount of such transaction be imposed through the FSA or the association of brokers and dealers in the market.⁸³

More importantly, Lord Donaldson MR indicated that he might look at the transaction differently if the bet was made on "artificial indices such as the aggregate of all race winners' numbers for each day of a meeting or, in the case of cricket,.."⁸⁴ And Lord Leggatt LJ was concerned that the words of "contract for differences" and "any other contract" were wide enough to include betting on sports and suggested that legislators might wish to amend the provision concerned to exclude sporting activities.⁸⁵

Returning to the main point of this section about the scepticism of the democratic institution to govern this issue, such a principle could well end up with the courts to determine the purpose of the financial instruments. Indeed, if such a principle is incorporated to Dodd-Frank, such a process to the courts or an independent semi judicial body which consists of retired judges or experienced lawyers in the OTC derivatives cases could be included as part of the regulations.

More importantly, it is necessary, even if its future might appear precarious in the light of Lynn Stout's scepticism of democratic governance. Such a principle as suggested is necessary because of its ethical and moral content and it is this aspect which might secure its future or at least made it difficult for its removal. Supporters for such an amendment amount to a public statement of their own ethical standard on the issue. It is also necessary that such a principle is stated in a modern regulation like Dodd-Frank because such a legal principle if set out in a gaming statute would be perceived by the public as antiquated law.

VI Conclusion

We need to remember that Dodd-Frank has been put in place in response to the G20 Leaders Summit held in Pittsburgh to regulate the excesses in the financial market. Dodd-

⁸³ *City Index*, at 7 LexisNexis.

⁸⁴ *City Index*, at 3 LexisNexis.

⁸⁵ *City Index*, at 11 LexisNexis.

Frank has not stated a principled position about the excesses in trading of OTC derivatives. There is therefore no guideline for the regulators that provide a framework for their many tasks on OTC derivatives. The existing guidelines relate more to the risk exposures that might destabilise the financial market. Whilst such an approach is necessary for the short term, it is short sighted for the future of the market. John Kay's summary view of the current regulatory measures is expressed as follows:⁸⁶

The primary objective of policymakers since the global financial crisis has been to secure the stability of the financial system. This objective has in turn been interpreted as securing the stability of existing financial institutions....Securing the stability of existing financial institutions was exactly the right short-term response to the global financial crisis, and exactly the wrong long-term response. The origins of the global financial crisis lay in the structure of the industry.

The structure of the industry requires considering the way the OTC derivatives as financial instruments been employed and the factors which drive them to be traded to excesses. The problem is compounded by the fact that such derivatives product is complex which put the regulators at a disadvantage. It requires the manufacturers and dealers of the product to actively participate in the regulation.

The dialogic process regulation as suggested by Dan Awrey would provide a model for this purpose. The regulatory rules would be initiated by the makers of the market through a dialogue process with the regulators. But it needs a principle to be carved out from Dodd-Frank of such engagement between the interested parties. It is suggested that such a principle be that OTC derivatives employed for the predominant purpose of speculation for profit is unlawful. Such a principle clearly suggests a connection of the excesses in OTC derivatives with speculation. It is a principle which is anti-speculation which is consonant with the legislative history of the United States on speculation. The principle also has a practical implication. It is not simply an abstract concept. It is a principle which the English judges applied in derivatives cases. The principle is borne out of their experience in hearing derivatives cases. In most of the derivatives cases, the judiciary is faced with the issue as to the purpose of the financial instruments engineered from OTC derivatives: whether they are deployed for hedging or speculation? So, there are guidelines for the regulators from the court cases. Furthermore such a principle expresses clearly an ethical or moral principle; this may not be so easily subject to such "democratic pressure" to legislative amendment. Indeed it is its moral and ethical content that would ensure its survival in the regulation.

Word count:

The text of this paper (excluding table of contents, footnotes, bibliography and this word count) comprises 11,825 words.

⁸⁶ John Kay *Other People's Money. Masters of the Universe or Servants of the People?* (Profile Books Ltd, London, 2015) at 270-271.

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