Miller, Financial Innovation: Achievements and Prospects, in Chew (ed.), The New Corporate Finance: Where Theory Meets Practice 343–444 (1993).

Miller understated the point. By the end of 2010, according to the Bank for International Settlements, the notional amount basis of all derivative instruments turned over on derivatives exchanges internationally was $601 trillion. Risk management respecting derivatives had been intensively discussed for years by business and regulatory actors worldwide but without much in the way of results until the financial crisis of 2008.

1. OVERVIEW

The Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States

46–58 (2011).

* * * The derivatives markets are organized as exchanges or as over-the-counter (OTC) markets, although some recent electronic trading facilities blur the distinctions. The oldest U.S. exchange is the Chicago Board of Trade, where futures and options are traded. Such exchanges are regulated by federal law and play a useful role in price discovery—that is, in revealing the market's view on prices of commodities or rates underlying futures and options. OTC derivatives are traded by large financial institutions—traditionally, bank holding companies and investment banks—which act as derivatives dealers, buying and selling contracts with customers. Unlike the futures and options exchanges, the OTC market is neither centralized nor regulated. Nor is it transparent, and thus price discovery is limited. No matter the measurement—trading volume, dollar volume, risk exposure—derivatives represent a very significant sector of the U.S. financial system.

The principal legislation governing these markets is the Commodity Exchange Act of 1936, which originally applied only to derivatives on domestic agricultural products. In 1974, Congress amended the act to require that futures and options contracts on virtually all commodities, including financial instruments, be traded on a regulated exchange, and created a new federal independent agency, the Commodity Futures Trading Commission (CFTC), to regulate and supervise the market. Outside of this regulated market, an over-the-counter market began to develop and grow rapidly in the 1980s. The large financial institutions acting as OTC derivatives dealers worried that the Commodity Exchange Act's requirement that trading occur on a regulated exchange might be applied to the products they were buying and selling. In 1993, the CFTC sought to address these concerns by exempting certain nonstandardized

OTC derivatives from that requirement and from certain other provisions of the Commodity Exchange Act, except for prohibitions against fraud and manipulation.

As the OTC market grew following the CFTC's exemption, a wave of significant losses and scandals hit the market. Among many examples, in 1994 Procter & Gamble, a leading consumer products company, reported a pretax loss of $157 million, the largest derivatives loss by a nonfinancial firm, stemming from OTC interest and foreign exchange rate derivatives sold to it by Bankers Trust. Procter & Gamble sued Bankers Trust for fraud—a suit settled when Bankers Trust forgave most of the money that Procter & Gamble owed it. That year, the CFTC and the Securities and Exchange Commission (SEC) fined Bankers Trust $10 million for misleading Gibson Greeting Cards on interest rate swaps resulting in a mark-to-market loss of $23 million, larger than Gibson's prior-year profits. In late 1994, Orange County, California, announced it had lost $1.5 billion speculating in OTC derivatives. The county filed for bankruptcy—the largest by a municipality in U.S. history. Its derivatives dealer, Merrill Lynch, paid $400 million to settle claims. In response, the U.S. General Accounting Office issued a report on financial derivatives that found dangers in the concentration of OTC derivatives activity among 15 major dealers, concluding that "the sudden failure or abrupt withdrawal from trading of any one of these large dealers could cause liquidity problems in the markets and could also pose risks to the others, including federally insured banks and the financial system as a whole." While Congress then held hearings on the OTC derivatives market, the adoption of regulatory legislation failed amid intense lobbying by the OTC derivatives dealers and opposition by Fed Chairman Greenspan. * * *

Debate intensified in 1998. In May, the CFTC under Chairperson Brooksley Born said the agency would reexamine the way it regulated the OTC derivatives market, given the market's rapid evolution and the string of major losses since 1993. The CFTC requested comments. It got them.

Some came from other regulators, who took the unusual step of publicly criticizing the CFTC. On the day that the CFTC issued a concept release, Treasury Secretary Robert Rubin, Greenspan, and SEC Chairman Arthur Levitt issued a joint statement denouncing the CFTC's move: "We have grave concerns about this action and its possible consequences…. We are very concerned about reports that the CFTC's action may increase the legal uncertainty concerning certain types of OTC derivatives." They proposed a moratorium on the CFTC's ability to regulate OTC derivatives.

For months, Rubin, Greenspan, Levitt, and Deputy Treasury Secretary Lawrence Summers opposed the CFTC's efforts in testimony to Congress and in other public pronouncements. As Alan Greenspan said: "Aside from safety and soundness regulation of derivatives dealers

under the banking and securities laws, regulation of derivatives transactions that are privately negotiated by professionals is unnecessary." In September, the Federal Reserve Bank of New York orchestrated a $3.6 billion recapitalization of Long-Term Capital Management (LTCM) by 14 major OTC derivatives dealers. An enormous hedge fund, LTCM had amassed more than $1 trillion in notional amount of OTC derivatives and $125 billion of securities on $4.8 billion of capital without the knowledge of its major derivatives counterparties or federal regulators. Greenspan testified to Congress that in the New York Fed's judgment, LTCM's failure would potentially have had systemic effects: a default by LTCM "would not only have a significant distorting impact on market prices but also in the process could produce large losses, or worse, for a number of creditors and counterparties, and for other market participants who were not directly involved with LTCM."

Nonetheless, just weeks later, in October 1998, Congress passed the requested moratorium.

Greenspan continued to champion derivatives and advocate deregulation of the OTC market and the exchange-traded market. "By far the most significant event in finance during the past decade has been the extraordinary development and expansion of financial derivatives," Greenspan said at a Futures Industry Association conference in March 1999. "The fact that the OTC markets function quite effectively without the benefits of [CFTC regulation] provides a strong argument for development of a less burdensome regime for exchange-traded financial derivatives." The following year—after Born's resignation—the President's Working Group on Financial Markets, a committee of the heads of the Treasury, Federal Reserve, SEC, and Commodity Futures Trading Commission charged with tracking the financial system and chaired by then Treasury Secretary Larry Summers, essentially adopted Greenspan's view. The group issued a report urging Congress to deregulate OTC derivatives broadly and to reduce CFTC regulation of exchange-traded derivatives as well.

In December 2000, in response, Congress passed and President Clinton signed the Commodity Futures Modernization Act of 2000 (CFMA), which in essence deregulated the OTC derivatives market and eliminated oversight by both the CFTC and the SEC. The law also preempted application of state laws on gaming and on bucket shops (illegal brokerage operations) that otherwise could have made OTC derivatives transactions illegal. The SEC did retain antifraud authority over securities based OTC derivatives such as stock options. In addition, the regulatory powers of the CFTC relating to exchange-traded derivatives were weakened but not eliminated.

The CFMA effectively shielded OTC derivatives from virtually all regulation or oversight. Subsequently, other laws enabled the expansion of the market. For example, under a 2005 amendment to the bankruptcy laws, derivatives counterparties were given the advantage over other

creditors of being able to immediately terminate their contracts and seize collateral at the time of bankruptcy.

The OTC derivatives market boomed. At year-end 2000, when the CFMA was passed, the notional amount of OTC derivatives outstanding globally was $95.2 trillion, and the gross market value was $3.2 trillion. In the seven and a half years from then until June 2008, when the market peaked, outstanding OTC derivatives increased more than sevenfold to a notional amount of $672.6 trillion; their gross market value was $20.3 trillion.

NOTE: EARLY WARNINGS

The Financial Crisis Inquiry Commission (FCIC) discusses two cases where bond market volatility caused sudden and destabilizing losses on derivatives. One is the 1998 collapse and bail out of Long Term Capital Management, L.P. ("LTCM"). The second, a series of cases not dissimilar in substance, occurred in the bond markets of 1994.

1. ***The LTCM Collapse.***

LTCM was a premier hedge fund. Its principals included John Meriwether, who earlier had pioneered fixed income arbitrage at Salomon Bros., David Mullins, a former Harvard economics professor and Federal Reserve vice chairman, and the Nobel prize winning

economists Myron Scholes and Robert Merton. LTCM had a range of investments, but the core of its portfolio was made up of arbitrage positions based on computer models of market behavior patterns. More particularly, LTCM specialized in detecting temporary price discrepancies between different types of debt securities and predicting the direction of price movements based on models derived from past market behavior. In 1998 its models indicated a price discrepancy between U.S. Treasuries—thought to be overpriced—and a range of other bonds, including junk bonds, mortgage-backed securities, and European government bonds—all thought to be underpriced. LTCM accordingly shorted U.S. Treasuries and went long in the other bonds.

Unfortunately, LCTM's models did not allow for the sequence of events that played out in practice in 1998. Many stock markets worldwide were plunging. Then, in mid-August, Russia devalued the ruble and defaulted on its debt. A worldwide flight to quality resulted. Investors bought U.S. Treasuries, causing their yields to fall and prices to rise, and simultaneously sold riskier debt like junk bonds and European government issues. Meanwhile, the fall in the rate on Treasuries caused domestic mortgage interest rates to fall, causing some mortgage-backed securities to lose value. As a result, LTCM's bets all went in the wrong direction at once. Had the firm not been highly levered, it might have been in a position to ride out the storm and wait for the pricing pattern predicted in its models to reassert itself. But LTCM was very, very highly levered.

Part of LTCM's problem lay in the fact that it was not the only firm making arbitrage plays based on computer models. As more and more players got into that game, yields on particular bets declined. To keep up a high yield on equity invested—routinely 40 percent per year before the

trouble—LTCM borrowed heavily to finance a higher volume of bets. At one point LTCM's assets exceeded its equity capital by 100 times, with borrowing providing the rest of the stakes. Its assets shrank as the bets went wrong—as of August 1998 LTCM had a balance sheet of $125 billion of assets, 54 times its equity capital base of $2.3 billion. By September, when its lenders made margin calls, LTCM's assets had shrunk to $80 billion and its capital to $600 million.

A bail out followed. Fifteen leading financial institutions drawn from among LTCM's lenders loaned an additional $3.5 billion. They took 90 percent of LTCM's equity in exchange. The bailout was brokered by Federal Reserve Chair Alan Greenspan. He later stressed that it was not undertaken to benefit LTCM's principals but to minimize a systemic threat to world financial markets that would result from a default on LTCM's mountain of debt.

Lax lending practices were implicated. LTCM's principals had potent reputations and a brilliant track record, making financial institutions eager to lend to the firm. LTCM insisted on secrecy respecting its positions, so as to avoid sharing yields with imitators. So eager were the lenders that they accepted this condition and loaned billions without requiring basic information about LTCM's assets and positions. Nor did they require LTCM to maintain a level of equity capital sufficient to support its positions.

2. ***Bond Markets in 1994.***

In early 1994 bond markets were bullish worldwide, and many actors speculated on further price increases. Many of the speculators were hedge funds. Some of the larger hedge funds had invested heavily in internationally diversified portfolios of bonds, borrowing most of the capital on a short-term basis from banks. The funds, which expected bond prices to rise, were taking advantage of an interest rate spread. In addition, banks and securities firms aggressively wrote call options on bonds to the hedge funds and other bond speculators. The banks and brokerages that wrote the options carried inventories of bonds to hedge their exposure on the options in case of price increases. But these long positions in bonds did not fully cover the options written. Instead, the long positions were set pursuant to delta hedge programs derived from the Black-Scholes model. These programs signal adjustments in the long positions as prices move up and down. As prices move up, more bonds must be purchased to cover the increasingly in-the-money options (approaching full coverage as the market price approaches the striking price). As prices move down, bonds are sold because fewer are needed to cover the options as they move out-of-the-money, and the bond portfolio is losing value in any event.

In February 1994, the Federal Reserve Board raised short term interest rates for the first time since 1989. This had the expected effect of causing bond prices to fall rapidly in the United States and the unexpected effect of causing bond prices to fall rapidly in Europe as well. The hedge funds had to start selling European bonds to cover margin calls on their loans. Meanwhile, as bond prices fell, the delta hedge programs of the firms that had written the now out-of-money calls triggered massive sales of their own

bond inventories. This added to the downward price pressure. Losses were aggravated across the board because execution of the sell orders could not keep up with the changes in price. In addition, many of the speculators who had bought bond call options had paid for the premiums by simultaneously selling puts. As prices fell, the value of the puts rose rapidly, opening up a large potential loss exposure. To cover this exposure, the put writers had to sell their own bonds into the falling market, adding more selling pressure.

On another front, the largest hedge fund had placed a large bet that the dollar would rise against the yen. But a threatened trade war between the United States and Japan caused the yen to move upward sharply at the same time the bond markets fell. This resulted in additional selling pressure in the bond market because the fund had to raise cash to meet loan calls resulting from its foreign exchange loss.

2. PRE-CRISIS INITIATIVES

Exchange-traded futures and stock options have established places within the system of federal market regulation. The SEC regulates "securities," which include stocks, bonds, and options. The Commodity Futures Trading Commission regulates "futures," which include exchange traded futures on commodities, instruments, and indices. Viewed literally, swaps are neither securities nor futures. They are contracts between private parties governed by the contract law the parties select (most likely, New York law in a domestic transaction and British law in an international transaction). Since they originate over-the-counter and are not traded in a market, they arguably implicate neither the federal securities laws nor the federal commodities trading laws. And, as the FCIC notes, that was the pre-crisis regulatory result. The sole exception was the CFMA's amendment of section 10(b) to prohibit "any manipulative or deceptive device or contrivance" in connection with "the purchase or sale of any … security-based swap agreement." This left open the possibility of an SEC enforcement action in the subclass of disputes between institutional swap dealers and their customers.

Bank regulation also had an impact on swap market. Banking regulators directly exercised supervisory authority over the swaps market through bank examinations, reporting requirements, and capital requirements. But this oversight obtained only where a bank served as the institutional counterparty on a swap. Securities firms competed with the banks through special purpose swaps subsidiaries, which in turn come under indirect control of the SEC. For discussion of the regulation of counterparty relationships and the place of derivatives in the context of the federal securities and commodities trading regimes, see Partnoy, The Shifting Contours of Global Derivatives Regulation, 12 U. Pa. J. Int'l Econ. 421 (2001); Huang, A Normative Analysis of New Financially Engineered Derivatives, 73 S. Cal. L. Rev. 471 (2000).

The swaps market was otherwise remitted to market control and self-regulation. "Governance" was invoked as the best defense against abusive transactions and excessive risk-taking. The leading set of governance recommendations appeared in the Derivatives Policy Group Report: Framework for Voluntary Compliance, CCH Fed. Secs. L. Rep. ¶ 86,607 (March 9, 1995). Six large securities firms had formed the Derivatives Policy Group (DPG) at the suggestion of then SEC Chairman Arthur Levitt. After the LTCM bailout, two new groups were formed to grapple with the problem of derivative risk: the President's Working Group on Financial Markets (PWG) made up of representatives from the securities, commodities, and bank regulatory agencies, and Counterparty Risk Management Policy Group made up of industry leaders.

A May 1999 PWG Report recommended, *inter alia*, (1) that financial institutions enhance their practices respecting counterparty risk management and disclose information concerning their exposure to highly leveraged institutions such as hedge funds; (2) the development of means to assure public disclosure of information respecting hedge funds, in particular value-at-risk or stress test results; (3) that regulators of broker-dealers and futures commission merchants be given expanded authority over the firms' unregulated affiliates; and (4) that regulators take up the problem of creating incentives to encourage offshore financial centers to comply with international standards.

The PWG pronounced again in 2007 with a set of "Principles and Guidelines regarding Private Pools of Capital." These addressed concerns stemming from the growing prominence of hedge funds in the derivative market. Self-regulation and counterparty vigilance continued as the themes. Here the "overarching principles" articulated by the PWG:

> The vitality, stability, and integrity of our capital markets are a shared responsibility between the private and public sectors. Market discipline most effectively addresses systematic risks posed by private pools of capital. Supervisors should use their existing authorities with respect to creditors, counterparties, investors, and fiduciaries to foster market discipline on private pools of capital. Investor protection concerns can be addressed most effectively through a combination of market discipline and regulatory policies that limit direct investment in such pools to more sophisticated investors.

3. DODD-FRANK

Risk taking in the swaps market did not cause the financial crisis of 2008. That distinction must be accorded to risk taking in the market for residential mortgages. But swaps, particularly credit default swaps, described in Chapter 8, infra, accelerated and magnified the impact of the mortgage market's collapse. When Lehman Brothers collapsed, leaving behind an opaque $21 billion over-the-counter dealer portfolio and a wave of cancelled transactions and unmet claims, a new and

substantial dose of downside risk shook the markets at an inopportune time.

Thus did swaps finally come up for regulation in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111–203, H.R. 4173.

Dodd-Frank title VII reverses the Commodity Futures Modernization Act of 2000 to bring swaps under federal regulation. The regulatory division between the CFTC and the SEC continues, with the CFTC regulating "swaps" as defined and the SEC regulating "security-based swaps," as defined. Most swaps fall on the CFTC side of line, including those based on broad-based securities indices; SEC jurisdiction covers swaps based on a single security or a narrow-based index. The Act's provisions across the two categories are almost identical; accordingly the division will not be reflected in this discussion.

The swaps covered include credit default swaps, interest rate swaps, and total return swaps covering a range of assets. Currency swaps are included contingently, subject to a later determination by the Treasury that they should not be included, a determination to be made pursuant to enumerated factors. Currency swaps will be subject to the Act's antifraud provisions at all events.

The Act seeks to push swap creation and trading away from the OTC platform and into new clearinghouses, called central clearing counterparties (CCPs). The CCPs offer standardized contracts and act as counterparties to all buyers and sellers. They are expected to import transparency and minimize counterparty default risk. All contracts are standardized, a short position automatically matches every long position, and all the exchange's counterparties must post a margin. In theory, this arrangement reduces counterparty default risk (and therefore systemic risk) by assuring balanced exposures and limiting a given counterparty's exposure to the CCP itself rather than to a broad range of other financial institutions. The CCP also serves as a regulatory focal point for imposition of capital and liquidity standards on all players.

The Dodd-Frank mandate is not absolute—although most swaps are available only at clearinghouses, others remain available OTC. The CFTC and the SEC are accorded the power to determine which swaps must be cleared. In so doing, the agencies are required to consider, *inter alia*, notional exposures, trading liquidity, pricing data, the availability of operational expertise and infrastructure, and effects on competition and systemic risk. All swaps subject to the clearing requirement must be traded on a board of trade designated as a contract market or a securities exchange or through a swap execution facility, unless no such entity accepts the swap for trading. A "swap execution facility" is a trading system or platform that extends to participants the ability to execute or trade swaps by accepting bids and offers made by facility's participants. There is an exemption for commercial end users—nonfinancial

companies that use swaps to hedge and make reports to the SEC and CFTC concerning their financial exposures respecting OTC swaps.

Two categories of swap market player are designated for regulation. "Swap dealers," are actors that deal, make markets in, or enter into swaps for their own accounts as a part of a regular business. "Major swap participants" are either (a) non-dealers that take major swap positions (excluding hedges) leading to substantial counterparty exposure with potentially adverse economic consequences, or (b) non-dealers that are leveraged financial companies as designated by the SEC or CFTC. The agencies are to articulate "business conduct" standards for these entities covering fraud, fair dealing with counterparties (particularly pension fund customers), adherence to position limits, and other supervisory diligence. Both swap dealers and major swap participants are be subject to capital requirements and, as regards their uncleared swaps, margin requirements.

The transition to CCPs has been substantially accomplished. When the Dodd-Frank mandates became effective in 2013, the CCPs suddenly became the venue for 90 percent of trading activity.

The CCP transition raises as many questions as it answers. CCPs do absorb risks. But they also concentrate them. ICE Clear Credit dominates the dollar-denominated segment with upwards of 80 percent of the contracts. There is a transformative aspect. Margin arrangements, introduced to reduce risk, also create it: an ICE Clear Credit margin call against a big player could have disruptive consequences. The banks remain in the system as risk bearers—they now participate on an indirect basis. Each big bank has multiple exposures to CCPs: it is a user of the services of several of them; it is an equity investor in one or more of them; it is as a lender to one or more of them; and it is a provider of depository and custodial services to one or more of them. Critics, variously pointing out new risks implicit in the structure, question its safety and soundness.

NOTE: GOVERNANCE AND DISCLOSURE

Implementing a Dodd-Frank mandate, the SEC has promulgated proxy disclosure rules regarding hedging in a new Item 407(i) to Regulation S-K. These require a description of "any practices or policies that the registrant has adopted regarding the ability of employees (including officers) or directors of the registrant, or any of their designees, to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds), or otherwise engage in transactions, that hedge or offset, or are designed to hedge or offset, any decrease in the market value of registrant equity securities—(i) [granted] to the employee or director by the registrant as part of the compensation of the employee or director; or (ii) [held], directly or indirectly, by the employee or director." Gordon,

Bernstein, and Lash, in a memorandum of Frederic W. Cook & Co. survey the first proxy statements subject to the rule (filed in 2019) to show: (1) 100 percent of the

244

companies had hedging policies in place; (2) 62 percent had hedging policies that covered directors and all employees; and (3) 58 percent disclosed policies that prohibited both transactions in company stock with a hedging function and derivative transactions generally.

4. COUNTERPARTY RELATIONSHIPS

(A) CONTRACT AND BANKRUPTCY

The default risk on a swap lies between that on a forward contract and that on a futures contract. The forward entails the greatest credit risk because the performance period extends to the length of the contract. A futures contract entails the least credit risk because the futures exchanges reduce the performance period to one day and require market participants to maintain margin accounts. Swaps require periodic performance on an intermediate timetable, usually quarterly or semiannually. Accordingly, they entail some credit risk. Historically, swap contracts have mitigated this default risk with **early termination provisions** triggered by a counterparty's bankruptcy, insolvency, or payment default. The disadvantaged party in effect cuts its losses and avoids future losses that could result from rate or price changes that increase the magnitude of future payment defaults.

Section 560 of the Bankruptcy Code exempts these early terminations from the automatic stay provision in section 365 of the Code. Section 561 assures the effectiveness of a **netting provision** commonly included in swap agreement termination clauses. Pursuant to the netting provision, the solvent counterparty can terminate and net out all outstanding swaps with the insolvent counterparty. The netting provision is designed to prevent the bankruptcy estate from selectively affirming those swaps that are in the money while disaffirming unfavorable contracts. Congress extended this treatment in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which added section 561. This shields contractual rights under a wide range of **master netting agreements** from the automatic stay. More specifically, the section covers rights arising: (1) from the rules of a derivatives clearing organization, multilateral clearing organization, securities clearing agency, securities exchange, securities association, contract market, derivatives transaction execution facility, or board of trade, (2) under the common law, or (3) by reason of normal business practice.

For criticism, see Roe, The Derivative Market's Payments Priorities as Financial Crisis Accelerator, 63 Stan. L. Rev. 539, 541–42 (2011):

> A failing firm's bankruptcy filing strips its creditors of rights that they would otherwise have. First, the Bankruptcy Code bars the debtor's creditors from suing the debtor for repayment, bars them from trying otherwise to collect debts due from the bankrupt, and—if the creditors are secured—bars

245

> them from immediately seizing or liquidating their security. Second, creditors who are repaid on an old loan in the ninety days before bankruptcy often must return those payments to the bankrupt, thereby allowing all creditors to share in that value. Third, ordinary creditors, unlike derivatives counterparties, lack the right without court permission to set off as many of their own debts due to the debtor against debts due from the debtor. Fourth, bankrupts can recover prebankruptcy fraudulent conveyances—which arise when the debtor sells its own assets for less than their fair value—for the benefit of all of the bankrupt's creditors. Fifth, the Code limits most creditors' and suppliers' rights to terminate contracts with the bankrupt. Sixth, creditors cannot terminate their contracts with a bankrupt if the firm files to reorganize its finances in Chapter 11.
>
> For creditors holding derivatives and repurchase agreements with the bankrupt, each rule is reversed to favor the derivatives and repo creditors. First, these counterparties can immediately collect on their debts at the beginning of a bankruptcy while other creditors cannot. Second, they need neither return eve-of-bankruptcy preferential payments on old debts nor give back preferential collateral calls that other creditors must return. Third, they have broader setoff rights that allow them to escape handing over money they owe to the debtor. Fourth, they are exempt from most fraudulent conveyance liability. Fifth, derivatives counterparties can choose whether or not to terminate contracts. Sixth, they need not suffer the debtor's typical bankruptcy option to assume or reject the underlying contract. The total impact of these exemptions and special rules is to give the favored creditors a superpriority over disfavored creditors.

Roe argues that the effective priority weakens incentives for credit market discipline.

Historically, most credit risk respecting swaps has been borne by financial intermediaries. Currency and interest rate swaps differ from the early parallel loans in that the hedging counterparties do not contract with one another. Instead, an intermediary enters into a swap with one party, and then either offsets the position with a counter transaction with another party, hedges the exposure with a financial futures contract, or simply takes the risk.

Legal uncertainty respecting swaps, particularly in respect of the contingency of counterparty insolvency, is mitigated through the use of a standard form contract developed by the **International Swaps and Derivatives Association** (ISDA), a trade association of swaps dealers. Counterparties fill in key terms as to price, duration, and quantity on a deal-by-deal basis.

246

Unlike futures and options, swaps were not exchange-traded until Dodd-Frank mandated the creation of CCPs. Indeed, under the standard ISDA form, they were neither tradable nor assignable without each counterparty's consent. To the extent a secondary market in swaps existed, it ordinarily involved the unwinding of positions through the creation of a mirror image contract that in effect cancels the original (this avoids any taxable income that would be realized on a direct cancellation and settlement). Alternatively, a counterparty desiring to unload an exposure could do so by entering into an opposite swap with a third party. Notional amounts outstanding ballooned as a result. Movement to CCPs has effected a considerable reduction of the notional amount outstanding. In addition, parties now "compress" their portfolios, consolidating duplicative transactions. Many counterparties to swaps also mark their positions to market for internal risk monitoring purposes.

In the swaps market they used to repeat the phrase, "know your counterparty." This meant that default risk depended on the counterparty's financial health and risk reduction implied diligence respecting the counterparty. Large players did not stop with informational diligence, however. They included margin requirements in their contracts. In 2008, margin calls respecting credit default swaps written by Bear Stearns and AIG hastened both companies' lapses into insolvency. Note also that one may know one's counterparty but not know one's counterparty's counterparty. Networks of exposures in the credit derivative market became so complex that no single counterparty, however large, could assess its own exposure to default. Default risk became systemic. The result is the fundamental regulatory change pursuant to the Dodd-Frank Act of 2010.

(B) CORPORATE LAW RIGHTS AND DUTIES

Brane v. Roth

Court of Appeals of Indiana, First District, 1992.
590 N.E.2d 587.

■ RATLIFF, CHIEF JUDGE.

STATEMENT OF THE CASE

Paul H. Brane, Kenneth Richison, Ralph Dawes, and John Thompson (collectively "directors") appeal the award of $424,038.89 plus interest for Porter Roth, et al. (collectively "shareholders"), in an action against them as directors of the LaFontaine Grain Co-op ("Co-op"). We affirm.

* * *

FACTS

This case involves a shareholders' action against the directors of a rural grain elevator cooperative for losses Co-op suffered in 1980 due to the directors' failure to protect its position by adequately hedging in the

247

grain market. Paul Brane, Kenneth Richison, Ralph Dawes, and John Thompson were directors of Co-op in 1980. Eldon Richison was Co-op's manager that year who handled the buying and selling of grain. Approximately ninety percent of Co-op's business was buying and selling grain. The directors met on a monthly basis reviewing the manager's general report and financial reports prepared by Virginia Daihl, Co-op's bookkeeper. The directors also discussed maintenance and improvement matters and authorized loan transactions for Co-op. Requests for additional information on the reports were rare. The directors did not make any specific inquiry as to losses sustained in 1980.

The records show that Co-op's gross profit had fallen continually from 1977. After a substantial loss in 1979, Co-op's CPA, Michael Matchette, recommended that the directors hedge Co-op's grain position to protect itself from future losses. The directors authorized the manager to hedge for Co-op. Only a minimal amount was hedged, specifically $20,050 in hedging contracts were made, whereas Co-op had $7,300,000 in grain sales.

On February 3, 1981, Matchette presented the 1980 financial statement to the directors, indicating a net profit of only $68,684. In 1982, Matchette informed the directors of errors in his 1980 financial statement and that Co-op had actually experienced a gross loss of $227,329. * * * The directors consulted another accounting firm to review the financial condition of Co-op. CPA Rex E. Coulter found additional errors in Matchette's 1980 financial statement, which increased the gross loss to $424,038. * * * Coulter opined that the primary cause of the gross loss was the failure to hedge.

The court entered specific findings and conclusions determining that the directors breached their duties by retaining a manager inexperienced in hedging; failing to maintain reasonable supervision over him; and failing to attain knowledge of the basic fundamentals of hedging to be able to direct the hedging activities and supervise the manager properly; and that their gross inattention and failure to protect the grain profits caused the resultant loss of $424,038.89. * * *

DISCUSSION AND DECISION

* * *

[The trial court correctly applied] the standard of care set forth in IND.CODE § 23–1–2–11. In 1980, I.C. § 23–1–2–11 provided that a director shall perform his duties in good faith in the best interest of the corporation and with such care as an ordinarily prudent person in a like position would use in similar circumstances. The statute allows the director to rely upon information, reports, and opinions of the corporation's officers and employees which he reasonably believes to be reliable and competent, and public accountants on matters which he reasonably believes to be within such person's professional competence. * * *

* * *

Under [the "clearly erroneous"] standard of review, we find that there was probative evidence that Co-op's losses were due to a failure to hedge. Coulter testified that grain elevators should engage in hedging to protect the co-op from losses from price swings. * * * One expert in the grain elevator business and hedging testified that co-ops should not speculate and that Co-op's losses stemmed from the failure to hedge. * * *

Further evidence in the record supports the court's findings and its conclusions that the directors breached their duty by their failure to supervise the manager and become aware of the essentials of hedging to be able to monitor the business which was a proximate cause of Co-op's losses. Although the directors argue that they relied upon their manager and should be insulated from liability, the business judgment rule protects directors from liability only if their decisions were informed ones. See Hanson Trust PLC v. ML SCM Acquisitions, Inc. (2d Cir.1986), 781 F.2d 264, 275 * * *.

In W & W Equipment Co. v. Mink (1991), Ind.App., 568 N.E.2d 564, trans. denied, we stated that "a director cannot blindly take action and later avoid the consequences by saying he was not aware of the effect of the action he took. A director has some duty to become informed about the actions he is about to undertake." * * * Here, the evidence shows that the directors made no meaningful attempts to be informed of the hedging activities and their effects upon Co-op's financial position. Their failure to provide adequate supervision of the manager's actions was a breach of their duty of care to protect Co-op's interests in a reasonable manner. * * * The business judgment rule does not shield the directors from liability.

* * * [In Coddington v. Canaday, 157 Ind. 243, 61 N.E. 567 (1901)] our supreme court held that directors are not liable for mere errors of judgment, but that they are liable for losses occurring through their gross inattention to the business or their willful violation of their duties. * * * The Coddington case points out particular duties which were breached by bank directors, such as the duties of: knowing the company's general financial condition, knowing its solvency position, checking or preventing improvident or dishonest conduct of managers, examining corporate records and knowing the manner in which business is conducted, and supervising managers. * * * [T]he court determined the bank directors were grossly inattentive to the business and willfully violated their duties. The directors argue that this language requires "gross negligence" before liability is exacted. We disagree with the directors' interpretation and also note that * * * the proper standard of care is that set forth in I.C. § 23–1–2–11, which is not a gross negligence standard. The trial court's reference to Coddington reinforces the findings of the particular breaches of duties here and does not imply that a finding of gross negligence by Co-op's directors was necessary. Furthermore, the reference to Coddington shows the trial court required more than errors

in judgment before finding the directors were negligent. It was necessary that the trial court here decide whether the directors acted as ordinarily prudent persons in like positions in similar circumstances would have acted. The trial court applied that standard correctly. * * *

* * *

■ GARRARD, J., concurs.

■ SULLIVAN, J., concurs in result.

NOTE: HEDGING, SHAREHOLDER VALUE, THE CAPM, AND THE IRRELEVANCE HYPOTHESIS

Brane v. Roth, read broadly, implies that a well-advised board of directors should take a proactive stance toward hedging the risks of enterprise. But note that the Co-op in *Brane*, a membership corporation, was by definition closely held. Its equity participants accordingly were disabled from diversifying their investments. Even if the *Brane* ruling is appropriate for such a firm, does it follow that it would be appropriate for a publicly held corporation? More broadly, will a thorough-going hedging strategy enhance value for the shareholders of a publicly held corporation?

Portfolio theory and the CAPM, when taken together with the "irrelevance hypothesis" described Chapter 6, infra, provide a basis for a powerful three-pronged argument against such an "insurance" approach to risk management. See Duffie, Futures Markets 228–31 (1989). First, to the extent that the risks to be hedged are unsystematic, the shareholders themselves can and presumably will eliminate them through diversification. Second, the shareholders themselves can deal with aversion to any residual systematic risk by including the appropriate amount of riskless treasury securities in their portfolios. Third, to the extent that a particular source of systematic risk can be identified within the firm, shareholders not wishing to bear the risk may be able to construct their own home-made hedges with the result that the unhedged firm and the hedged firm have the same long run value. Note that the third prong of the argument, based on the irrelevance hypothesis, presumably applies to closely held firm like the co-operative in *Brane v. Roth* as well as to publicly held companies.

If the argument is correct, then the fully hedged firm in fact is less valuable than the unhedged firm to the extent of the transaction costs of hedging. The argument also invites us to ascribe appearances of aggressive corporate hedging to management self-interest. Under this view, managers who cannot diversify their investments of human capital hedge at the shareholders' expense toward the end of providing themselves with a stable institutional environment. Much hedging of currency exchange rate risk, for example, is conducted by multinational firms not to protect against disruption of actual financial transactions but to protect the firm's annual earnings figure from downward adjustment pursuant to GAAP. See Hu, Hedging Expectations: "Derivative Reality" and the Law and Finance of the Corporate Objective, 73 Tex. L. Rev. 985 (1995).

250

The argument against hedging is confronted in Hu, supra, in Romano, A Thumbnail Sketch of Derivative Securities and Their Regulation, 55 Md. L. Rev. 1 (1996), and in Krawiec, Derivatives, Corporate Hedging, and Shareholder Wealth: Modigliani-Miller Forty Years Later, 1998 U. Ill. L. Rev. 1039. Professors Hu and Romano note sticking points in applying the financial economic theories on which the argument is based and point out that we do not yet have conclusive empirical evidence on the connection between hedging and firm value. Hu's view, tentatively expressed, is that there is a risk that corporate hedging does proceed contrary to the interests of shareholders. For correctives he looks to the concept of shareholder expectations and disclosure policy. Shareholder expectations are critical here because they may differ—for example, some shareholders in natural resource companies may be seeking to speculate on volatile commodity prices, while others may prefer that those risks be hedged away. Managers, say Hu, should try to align their policies with their shareholders' expectations (to the extent that such expectations can be ascertained), and, in addition, should publicly disclose the major components of their hedging strategy.

Romano, supra, seconds the disclosure point. But she also takes pains to present a number of points "suggestive," id. at 39–39, of the proposition that corporate hedging has a value. These include (1) signaling—with full hedging the shareholders are better positioned to surmount the problem of information asymmetry and ascribe business reversals to management performance rather than to uncontrollable external shocks; (2) management compensation—the fully hedged firm justifiably can pay fixed compensation at a lower rate because it offers a less volatile working environment; and (3) investment policy—given that financing through internally generated cash flows is cheaper than new debt or equity financing, shocks to the firm's internal cash flows can cause it to forego good investment opportunities.

Professor Krawiec mounts a more sustained attack on the irrelevance hypothesis. She reviews the empirical evidence and concludes that, although it leaves open many questions, it is "generally consistent" with the proposition that hedging can enhance shareholder value. 1998 U. Ill. L. Rev. at 1082. She goes on to note that conglomerate mergers and derivatives hedging present two distinguishable types of corporate risk-reducing behavior and to show that empirical evidence of the wealth reduction due to conglomerate merger has provided the primary basis for the academic attack on the value of derivative hedging. She identifies seven means by which firm-level risk reduction can enhance shareholder value, id. at 1043: (1) if firm-level hedging reduces systematic risk; (2) if there are transaction costs associated with risky firms; (3) if the firm's investment policy fluctuates with its cash flows; (4) if agency costs can be reduced through firm-level risk reduction; (5) if hedging is a cost-effective substitute for vertical integration as a strategy for assuring a reliable input or output source; (6) if there are tax savings associated with reducing firm-level risk; and (7) if the firm's shareholders are not diversified. She concludes that the value of hedging varies from firm to firm.

251

Empirical results on the value of hedging are mixed but trend in a positive direction. For studies showing that hedging increases firm value (by 5 percent to 10 percent), see Allayannis and Weston, The Use of Foreign Currency Derivatives and Firm Market Value, 14 Rev. Fin. Studies 243 (2001); Carter, Rogers and Simkins, Does Hedging Affect Firm Value? Evidence from the U.S. Airline Industry, 35 Fin. Mgt. 53 (2006). For a mixed report, see Jin and Jorion, Firm Value and Hedging: Evidence from U.S. Oil and Gas Producers, 66 J. Fin. 893 (2006). Assuming that hedging can be value enhancing, where might the value come from? Campello, Lin, Ma and Zou, The Real and Financial Implications of Corporate Hedging, 61 J. Fin. 1615 (2011), compares companies that hedge with companies that do not and shows that hedging reduces the expected costs of financial distress by lowering the probability of loss. Hedgers gets the benefit of lower cost debt and are less likely to be required to submit to business covenants that restrict their capital expenditures. As a result, hedgers invest more capital.

It also turns out that companies possessing experience with derivatives sometimes graduate from hedging to speculation. This tends to happen when actors at the company conclude that their line of business yields informational advantages that can be turned to profit in the derivative markets. See Ge'zy et al., Taking a View: Corporate Speculation, Governance, and Compensation 62 J. Fin. 2405 (2007). See also Adam and Fernando, Hedging, Speculation, and Shareholder Value, 81 J. Fin. Econ. 283 (2006), which looks at derivative positions taken by the firms in the gold mining industry over a ten year period and finds that the portfolios produced substantial positive cash flows rather than netting out as hedging washes. The managers in effect incorporate their views about the direction of market prices into their hedging programs. Interestingly, there was no evidence of increased systematic risk for the firms in the sample.

Deephaven Risk Arb Trading Ltd. v. UnitedGlobalCom Inc.

Court of Chancery of Delaware, 2005.
2005 WL 1713067.

■ PARSONS, VICE CHANCELLOR.

Plaintiff, Deephaven Risk Arb Trading, Ltd. ("Deephaven"), is an investment fund and claims to have brought this action as a stockholder of UnitedGlobalCom, Inc., a Delaware corporation ("UGC"). * * *

* * *

I. FACTS

Deephaven is an investment fund that utilizes market-neutral investment strategies designed to deliver risk-adjusted returns with low volatility. Market-neutral strategies seek to capture mispricings or spreads between related capital instruments without being exposed to absolute price movements. These objectives are often achieved by combining long and short positions.

UGC is a large international broadband communications provider. On January 12, 2004, UGC announced a $1 billion rights offering (the "Rights Offering"). On the record date of the Rights Offering, UGC had outstanding 293,107,030 shares of Class A common stock ("Class A" or "Stock"), 8,198,016 shares of Class B common stock ("Class B") and 303,123,542 shares of Class C common stock ("Class C"). The Class A stock was publicly traded on the NASDAQ National Market and widely held. Liberty Media Corporation owned all of the Class B and Class C shares, giving it approximately 55% of the outstanding common stock and 92% of the cumulative voting power.

* * *

A. Deephaven's Dealings in UGC Stock and Rights

Following the announcement of the Rights Offering on January 12, 2004, Deephaven began actively trading UGC Stock. To do so, Deephaven utilized at least five brokerage accounts, at Barclays, Deutsche Bank, Goldman Sachs, Morgan Stanley and Salomon Smith Barney. It was often Deephaven's practice to borrow UGC shares in one of its accounts with the intention of short-selling them to itself in another Deephaven account. The result of that type of transaction is that Deephaven's purchase and sale prices are identical and no economic interest in UGC Stock is created—that is, Deephaven is not exposed to fluctuations in the value of UGC shares. Not all of Deephaven's UGC trades, however, were matched short-sales and purchases. Beginning January 13, 2004, and in earnest on January 22, Deephaven amassed a substantial net short position across its accounts. For example, on February 18, 2004, just two days before the final results of the Rights Offering were released, Deephaven was net short 4,615,071 shares of UGC.

Throughout that period, however, Deephaven's Barclays account consistently held a long position in UGC Stock. On January 13, 2004, Deephaven established a position of 2,050,000 shares in the Barclays account and that figure swelled to a high of 9,338,592 on March 3. In fact, aside from a three day period between March 5 and March 8, following the liquidation of the UGC position in its Barclays account, Deephaven held UGC shares long in the Barclays account at all times between

January 13 and August 23, 2004. In addition to buying and selling UGC shares, Deephaven also actively participated in the market for rights, purchasing millions of rights on the open market.

B. The Rights Offering

* * *

Under the terms of the Rights Offering, each right entitled its holder to a basic subscription privilege and an oversubscription privilege. Each share of Class A stock entitled stockholders to receive .28 rights and approximately 83 million Class A rights were distributed. The basic subscription privilege of each full Class A right allowed the holder to purchase one share of Class A stock at a price of $6.00—a 40% discount

253

to the then-current market price of approximately $10.00. The oversubscription privilege also entitled rightsholders who had exercised their basic subscription privilege in full to purchase additional shares of Stock. The number of shares available for oversubscription was to be equal to the number of shares made available by rightsholders that failed to exercise their basic subscription privileges. In other words, UGC sought to sell all of the Stock offered in the rights offering either through basic subscriptions or a combination of basic and oversubscriptions.

[The rights were distributed on January 21, 2004, and were freely tradable on the NASDAQ. The Rights Offering had its expiration date extended to February 12. To subscribe to the Rights Offering, stockholders were required to deliver a rights certificate together with payment of the full subscription price before the expiration date. Stockholders wishing to exercise their rights, but who were unable to deliver rights certificates by the expiration date were required to provide full payment and a notice of guaranteed delivery before expiration. Before the expiration date, Deephaven submitted 5,190,700 rights certificates, a request for 1 million oversubscription rights, and full payment for the requested shares.

[On February 13, 2004, UGC issued a press release announcing preliminary results—Class A rightsholders have subscribed for approximately 63.7 million shares pursuant to the basic subscription privilege and approximately 66.8 million shares pursuant to the oversubscription privilege. Based on these preliminary figures, Deephaven stood to receive the entire 1 million shares it requested from oversubscription rights. A week later, however, UGC issued a final press release stating that it had received subscriptions for approximately 82 million of the 83 million rights, leaving only about 1 million shares available for oversubscription. The February 13 press release explained the discrepancy by stating that the February 13 press release had excluded shares subscribed pursuant to the guaranteed delivery procedure. In the final allocation, Deephaven received just 34,603 oversubscription shares based on its exercised position of 5,190,700 basic rights and its request for 1,000,000 oversubscription rights.

[Deephaven's counsel thereafter wrote to UGC to express its concern over the sudden change in available rights and to request that all relevant files, documents, and other information be preserved. UGC responded with a denial of any "wrongful actions after the delivery deadline."

[Deephaven then wrote to UGC demanding inspection of certain categories of UGC's books and records pursuant to 8 Del. C. § 220 (Deephaven's "Demand Letter"). Specifically, the Demand Letter requested eleven categories of documents relating to various aspects of the Rights offering and the manner in which it was executed. UGC resisted the demand, and this action followed.]

254

II. ANALYSIS

* * *

1. Is ownership of individual shares of stock negated by a net short position?

* * *

At the time of the Rights Offering, Deephaven held over 4 million UGC shares long in its Barclays account. At the same time, Deephaven's net position across all of its brokerage accounts was more than 4 million shares short. According to UGC, because Deephaven was net short, "Deephaven did not own any UGC stock; it owed over 4 million shares to others." In other words, UGC contends that if an investor simultaneously holds a long position in a security and a larger short position in the same security, the investor does not "own" the shares held long. UGC offers no authority for this proposition, however, and it is unsupported by either the statute or practical considerations.

* * *

Section 220 is a summary proceeding. Historically, only record holders had standing to seek inspection rights. Proof that the plaintiff was a stockholder of record generally ended that portion of the analysis. For example, it has been held that "§ 220 does not require that a shareholder have a 'direct' economic interest in the stock she owns of record to be entitled to enforce the inspection right." In addition, record holders have inspection rights "even though the possibility exists that a stockholder may later be divested of this stock in some other proceeding or be declared in some future proceeding to be holding his stock contrary to law or private agreement."

The statute was amended in 2003 to, among other things, extend inspection rights to beneficial owners of stock. In describing the pertinent portion of the legislation, the bill explains: "inspection rights are extended to a person who beneficially owns stock through either a voting trustee or a nominee who holds the stock of record on behalf of such person." Importantly, neither the newly-amended statute nor the legislation itself indicates an intent to create two classes of inspection rights: one for record holders and one for beneficial holders. I interpret the 2003 amendment to afford to beneficial holders all § 220 rights previously held by record holders. Therefore, established law that record holders need not have an economic interest in stock to have inspection rights applies with equal force to beneficial holders such as Deephaven.

Practically, requiring an analysis of why and under what circumstances a § 220 plaintiff came to hold a company's shares could significantly complicate the nature of this summary and often expedited proceeding. To give effect to UGC's position potentially would force courts to undertake a complex analysis to determine the plaintiff's financial position net of stock, options and other derivatives. One can imagine cases in which financial experts might be necessary to make such a

determination. Moreover, the specter of being forced to disclose sophisticated and proprietary trading techniques could have a chilling effect on the use of § 220 by a substantial segment of stockholders. Finally, unlike in other situations such as voting, the § 220 analysis includes its own safeguard against plaintiffs with economic incentives that are not aligned with other stockholders: the proper purpose analysis. For all of these reasons, I see no grounds to discount Deephaven's beneficial ownership of UGC shares held at Barclays because it also held off-setting short positions.

2. Is a purchaser of one's own short sales a beneficial owner?

UGC argues that "[a]s a short seller, Deephaven was not a beneficial owner of UGC stock" and that "Deephaven's transfer of shares and cash from one pocket to the other pocket does not alter its status as a short seller and does not establish beneficial ownership." UGC's argument has two components. First, UGC argues that because a short sale involves borrowing shares in order to sell them, the short seller never "owns" the shares and never becomes a "beneficial owner." UGC then argues that Deephaven's transfer of borrowed shares to another of its brokerage accounts did not change their status as borrowed shares.

The first component of UGC's argument raises the interesting question of whether one who merely borrows shares, and does not sell them, becomes a beneficial owner. One would think not, but for present purposes the Court need not answer that question. It is sufficient to note that under Delaware law a purchaser of shares from a short seller is a beneficial owner. This result enables short selling in modern markets without necessitating quasi-title searches in connection with each stock purchase. The remaining question is whether Deephaven's short-sales to itself constitute normal sales or, as UGC argues, some other type of transfer. UGC's position is without merit. All transfers of Stock into Deephaven's Barclays account involved an exchange of cash for Stock. More importantly, once in the Barclays account, the shares were not linked to, or otherwise encumbered by, the short positions in the other Deephaven accounts. Once Deephaven paid for the shares in its Barclays account, it had all of the rights of ownership, including the right to dispose of them and to receive the corresponding subscription rights. UGC's interpretation would differentiate between stockholders that purchased shorted shares on the open market and those that purchased such shares from themselves. I question the wisdom of treating those two situations differently in determining beneficial ownership. Therefore, I hold that regardless of the method Deephaven used to finance the shares in its Barclays account, having paid for and held them, Deephaven beneficially owned the shares and had the necessary standing to bring this action.

NOTE: EMPTY VOTING

Deephaven's undertaking of an informational probe under § 220 from a net short position held out little apparent threat to the conduct of business at UGC. But the exercise of shareholder rights, particularly voting rights, by holders thus situated can have disturbing implications.

Consider the case of a proposed acquisition of King Pharmaceutical by Mylan Laboratories. As often happens when a merger agreement is concluded, the shares of the target, King, rose substantially, while those of the acquirer, Mylan, fell. Perry Corp., a large

hedge fund, held a large stake in King, and favored the merger. Carl Icahn, in contrast, held a large stake in Mylan, and opposed the merger. Perry acquired 9.9 percent of Mylan's shares for the purpose of voting them in favor of the merger. Perry simultaneously entered into equity swaps with Wall Street firms, thus taking a short position that fully hedged its exposure to a decline in Mylan's share price. Understandably, Icahn was much upset by the prospect that a Mylan holder thus situated might be in a position to influence the outcome of the vote.

Mylan eventually abandoned the King deal due to adverse facts uncovered during due diligence. See Kahan and Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021 (2007). But the issue raised by Perry's voting position persists. Perry, like Deephaven in the principal case, had no direct economic interest in Mylan even as it held 10 percent of the votes on the merger. Indeed, because its economic stake lay in a long position in the target's shares, its interest arguably was adverse to that of Mylan's other stockholders. Hu and Black, The New Vote Buying: Empty Voting and Hidden Morphable Ownership, 79 S. Cal. L. Rev. 811, 875–86 (2006), calls this situation **empty voting**. Note that swaps are not the only means to the end of uncoupling the vote from the underlying equity interest—short positions in stock can be effected through the purchase of puts, the sale of a single stock futures contract, or by a simultaneous short sale of the stock itself.

Note also that an empty voter's incentives will vary depending on its investment position. For example, if Hedge Fund X had a substantial short position in King stock upon the merger's announcement, it would have had an incentive to take the same position in Mylan stock as Perry for the purpose of voting against the merger. As to those empty votes, Carl Icahn presumably would have had no objection.

Thus do votes on mergers hold out a prospect of keenly conflicting incentives on the part of hedged investors. **In re MONY Group Shareholder Litigation**, 853 A.2d 661 (Del. Ch. 2004), describes a famous case of this. AXA, a large French insurer, entered into a merger agreement with MONY, the target. A number of hedge funds with substantial long positions in MONY objected on the ground that the price was too low. Meanwhile, AXA had issued convertible bonds to raise the cash for the merger consideration. The bond contract priced the option to convert into AXA common in the money, and the option's value quickly rose because AXA's stock went up after the announcement of the deal. But the bond

contract also provided that the bonds would be redeemed at a small premium in the event the merger failed. Holders of the bonds accordingly had a high-powered incentive to support the merger, and bought MONY stock in order to vote in favor. At the same time, one of the hedge funds that was opposing the deal shorted the bonds, thereby enhancing its payoff in the event of the merger's defeat. (The merger eventually passed by a small margin.)

Martin and Partnoy, Encumbered Shares, 2005 U. Ill.L. Rev. 775, sets out a range of situations in which offsetting positions can skew voting incentives. Assume that X Fund holds a significant number of Y Corp. shares and that the outcome of an upcoming shareholder vote will materially impact the price of Y's stock. How will X Fund's incentives differ from those of a holder whose only pertinent interest is a long position in Y stock:

1. If X's long position is offset by an equal number of short sales of Y stock?
2. If X purchases at-the-money put options on an equal number of Y shares?
3. If X sells call options on an equal number of Y shares?
4. If X sells put options on an equal number of Y shares?
5. If X purchases call options on an equal number of Y shares?
6. If X has a substantial holding of bonds issued by Y Corp.?
7. If X has shorted a substantial number of bonds issued by Y Corp?

What, if anything, should be done about empty voting? Hu and Black recommend an overhaul of the federal securities laws to import transparency respecting the overall investment positions of large holders. Martin and Partnoy make a more radical recommendation, proposing a rule under which shares held by stockholders who lack "the otherwise homogenous incentives generated by 'pure' share ownership" would not be entitled to vote.

(C) SECURITIES LAW

Caiola v. Citibank, N.A.

United States Court of Appeals for the Second Circuit, 2002.
295 F.3d 312.

■ BEFORE: SACK, B.D. PARKER, JR., and GIBSON, CIRCUIT JUDGES.

■ PARKER, CIRCUIT J.

Plaintiff-appellant Louis S. Caiola brought federal securities fraud and state law claims against defendant-appellee Citibank, N.A., New York arising from extensive physical and synthetic investments. The District Court (Denise L. Cote, *Judge*) granted Citibank's motion to dismiss the Complaint under Federal Rule of Civil Procedure 12(b)(6), finding that Caiola lacked standing under Rule 10b–5 to allege a violation of section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") because he was not a purchaser or seller of securities, his synthetic transactions were not "securities" as defined by the 1934 Act,