AlixPartners
when it really matters

FINANCIAL SERVICES

MAY 2017

Lessons from recent derivatives litigation and regulatory enforcement actions

Recent derivatives litigation and regulatory enforcement actions make it abundantly clear that derivatives shortcomings and outright abuses worsened the recent financial crisis.[1] The resulting derivatives litigation and regulatory enforcement actions provide a stern reminder that substantial damage can occur when derivatives are misused.[2]

This article summarizes some important lessons we can learn from the 428 federal court cases and 184 federal enforcement actions involving derivatives that were initiated between 2001 and 2013, more than half of which occurred right after the crisis in 2010 to 2013.

Here are the important takeaways:

- Derivatives are among the most complex financial instruments. They are often difficult to understand, use, and value.
- Derivatives increase exposure to specific risks, which tends to magnify potential gains but also losses. Surprisingly large losses can result when markets are volatile.
- Rapid over-the-counter (OTC) derivatives market growth opened the door to fraud and breach-of-contract disputes.
- Derivatives are frequently used by unscrupulous promoters to commit fraud because of their complexity, leverage, and lack of price transparency. They exploit investors' lack of familiarity by misleading them about the risks and potential returns.
- Rapid growth in the market for a new security, such as collateralized debt obligations (CDOs), may be difficult to manage and can have potentially

1 See "Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States," *Financial Crisis Inquiry Commission*, Washington, DC, 2010, at 255. UNT Digital Library, accessed March 9, 2016, http://purl.fdlp.gov/GPO/gpo50165, at xxiv and xxv.
2 Finnerty, John D., "What Lessons Can We Learn from Recent Derivatives Litigation and Regulatory Enforcement Actions?" *Securities Regulation Law Journal* 44, Winter (2016): 361-430.

> Derivative instruments are more complex than stocks and bonds, often difficult to understand, and challenging to value.

negative consequences if the new product is poorly designed and misunderstood.

- While derivative product sophistication seemed to grow in the years leading up to the financial crisis, risk management systems failed to keep pace, and regulators failed to spot the escalating problems.
- Derivatives regulation and enforcement have tightened due to the Dodd-Frank Wall Street Reform and Consumer Protection Act reforms.[3] But most derivatives still trade in fragmented OTC markets, these markets still lack price transparency, there is still only limited public reporting of derivatives positions, and significant systemic risk likely remains in the financial system.

DERIVATIVE INSTRUMENTS

Derivative instruments are more complex than stocks and bonds, often difficult to understand, and challenging to value. Their value depends on the value of some underlying asset price, reference rate, or index. This is important because a derivative's price can be manipulated through the underlying's cash price, such as manipulating the price of Brent crude oil to affect the price of Brent Crude Oil Futures contracts, or manipulating the price of one derivative contract to affect the price of another, such as manipulating the prices of natural gas futures contracts to affect the price of natural gas swaps.

Derivatives are an effective means of transferring risk. But they do not make risk disappear. One party hedges its risk exposure by transferring it to someone else. Derivatives increase exposure to specific risks, which tends to magnify potential gains and losses. Surprisingly large losses can result when markets are volatile. Lawsuits follow when investors sue to recoup their losses.

DERIVATIVES LITIGATION AND ENFORCEMENT ACTION TRENDS

Mounting concerns that the misuse of complex and highly toxic derivatives had contributed to the severity of the recent crisis led to passage of the Dodd-Frank reforms to try to prevent a recurrence of the abuses and reduce systemic risk. While derivative product sophistication seemed to grow as credit derivative products gained broad market acceptance, the risk management systems of some banks, insurance companies, and broker-dealers had failed to keep pace. And their regulators had failed to spot the problems.

Rapid growth of the OTC derivatives markets opened the door to fraud and abuse. These markets do not provide transparent pricing, which can lead to price disputes. More ominously, unscrupulous promoters exploited investors' lack of familiarity with the complex new instruments and misled them about the potential returns, the risks, and—as in the case of mortgage-backed securities—the quality of the underlying assets. Derivatives are frequently the instrument of choice when someone is intent on committing fraud because of their complexity (masks their true riskiness), leverage (magnifies the promoter's gain), and lack of transparency (makes it difficult to detect mispricing).

LEGAL AND ENFORCEMENT ACTIONS ACCELERATED AFTER THE CRISIS

Dodd-Frank established for the first time a comprehensive regulatory framework governing the OTC derivatives markets. Dodd-Frank requires

[3] Public Law 111-203: Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted July 21, 2010.

FIGURE 1: ANNUAL BREAKDOWN OF ENFORCEMENT ACTIONS AND PRIVATE LITIGATION INVOLVING DERIVATIVES, 2001 TO 2013[4]

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total
Enforcement actions	2	6	5	6	7	21	15	15	13	22	21	26	25	184
Private actions	11	12	8	8	13	27	12	19	38	90	74	60	56	428
Total	**13**	**18**	**13**	**14**	**20**	**48**	**27**	**34**	**51**	**112**	**95**	**86**	**81**	**612**

transparency in financial transactions and aims to limit abusive practices, reduce structural leverage, and decrease systemic risk in the financial system. Dodd-Frank expanded the Securities and Exchange Commission's (SEC) and the Commodity Futures Trading Commission's (CFTC) regulatory authority over the derivatives markets. Their regulatory reach is now much broader, and they have tightened enforcement.

Table 1 illustrates the more aggressive SEC and CFTC enforcement. The numbers of derivatives enforcement actions and private causes of action accelerated in 2010 in response to the crisis. More aggressive enforcement has resulted in financial institutions paying large fines for derivatives-related transgressions.

CDO AND CDS CASES BECAME MORE PROMINENT

Table 2 provides a case breakdown by derivative instrument. Options cases are most common, usually alleging that investment advisors misled investors about the risks and profitability of recommended option strategies. Options' built-in leverage increases potential profit but also increases investor losses if they are misused.

The numbers of CDO and credit default swaps (CDS) cases grew sharply in 2009 and 2010. CDSs have been blamed as one of the root causes of the crisis. Their use has fallen dramatically since the crisis ended.

MORTGAGE-RELATED CASES BECAME MORE PROMINENT

Table 3 provides a case breakdown by underlying asset. Foreign currency and commodity derivatives are most prominent. Common cases involve either hedges that failed to perform as expected, or speculation that resulted in unexpected losses, which the speculator tries to recoup by alleging that the promoter fraudulently misrepresented the trading strategies or overstated the investment results when soliciting funds.

The recent crisis started when the mortgage-backed securities (MBS) market suffered a meltdown in 2007. Securities dealers had aggressively securitized subprime mortgages and Alternative A-paper (Alt-A) mortgages, which required minimal documentation and were thus ripe for fraud. The mortgage collateral had very high default rates. The mix of cases shifted toward CDS, CDOs, and MBS (which were the underlying for many CDOs and CDSs) during 2009 to 2013, the derivative instruments most often blamed for the financial crisis.

FIGURE 2: ANNUAL BREAKDOWN OF CASES BY TYPE OF DERIVATIVE INSTRUMENT, 2001 TO 2013[5]

Derivative instrument	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total
CDO	0	0	2	2	0	2	0	1	8	21	17	13	15	81
CDS	1	1	0	0	0	1	1	2	6	14	12	9	12	59
Other swaps	1	2	4	2	2	8	2	8	5	7	7	9	6	63
Options	6	8	4	5	13	33	15	17	15	31	27	24	17	215
MBS (CMO, IO, PO, etc)	2	0	0	0	0	1	0	0	6	20	16	16	5	66
Other structures	0	0	0	0	0	0	1	1	1	0	0	0	0	3
Repo	0	1	0	0	0	0	0	2	2	4	3	6	1	19
Futures/forwards	4	7	4	6	6	6	8	6	13	24	18	16	24	142
Total	**14**	**19**	**14**	**15**	**21**	**51**	**27**	**37**	**56**	**121**	**100**	**93**	**80**	**648**

4 Finnerty, John D., "What Lessons Can We Learn from Recent Derivatives Litigation and Regulatory Enforcement Actions?" *Securities Regulation Law Journal* 44, Winter (2016): 361-430.

5 Ibid

FIGURE 3: ANNUAL BREAKDOWN OF CASES BY UNDERLYING ASSET, 2001 TO 2013

Underlying asset	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total
Bond	3	3	1	2	0	7	4	4	11	14	7	11	6	73
Equity	3	3	1	2	2	7	7	3	7	17	19	15	14	100
Interest rate	1	1	1	1	2	7	2	7	3	5	3	7	5	45
Currency	0	5	5	5	11	22	14	11	8	11	9	4	5	110
Commodity	5	5	2	3	3	10	3	7	11	17	15	14	14	109
Loan	0	0	1	1	0	1	0	1	2	3	1	3	2	15
Mortgages	2	0	0	0	0	1	0	0	9	26	18	18	12	86
CDO	0	0	0	0	0	0	0	1	10	11	9	8	9	48
Swaps	1	1	0	0	0	0	0	0	1	7	0	1	3	14
ABS/MBs	0	0	0	0	0	0	0	0	3	22	15	10	14	64
Total	15	18	11	14	18	55	30	34	65	133	96	91	84	664

MOST FREQUENTLY CITED ALLEGATIONS: FRAUD AND BREACH OF CONTRACT

Table 4 provides a case breakdown by allegation. The recent crisis illustrates how rapid growth in the market for a new security, such as CDOs, may be difficult to manage with potentially negative consequences when the new product is poorly designed and not fully understood. The sheer complexity of the contracts increases the likelihood of misunderstandings. Fraud causes of action can result when the financial risks are not properly disclosed and fully understood.

Fraud (including securities fraud) is alleged in 60% of the cases, and breach of contract is alleged in 28% of the cases. The high percentage of fraud cases is likely due to the complexity of derivative instruments. Unscrupulous promoters often misrepresent the risks and returns to attract investors. Complexity facilitates their misuse because investors would arguably be less likely to accept the misrepresentations if the contracts were simpler and more transparent.

Fraud was among the most frequent allegations in CDO and CDS cases and in cases alleging manipulation of commodity prices, interest rates, and commodity futures and option contract prices. Breach of contract was among the most frequent allegations in credit derivatives and swap cases when serious derivatives pricing disputes grew into breach of contract allegations.

SUMMING UP: THE DERIVATIVES MARKET OUTLOOK

The derivatives market outlook is for greater transparency in transactions, tighter regulatory oversight, greater contract standardization, and more trading on derivatives exchanges and cleared through well-capitalized and closely regulated clearinghouses. The outlook is somewhat clouded because specific provisions of Dodd-Frank may be repealed in the coming months. The recent history of litigation and enforcement does not portend boom times for derivatives products anytime soon. Market

FIGURE 4: ANNUAL BREAKDOWN OF DERIVATIVES-RELATED CASES BY TYPE OF ALLEGATION, 2001 TO 2013[7]

Allegation	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total
Fraud	6	8	6	4	7	24	17	16	15	50	47	35	53	288
Securities fraud	4	1	2	3	2	5	3	3	12	17	10	5	11	78
Civil conspiracy	0	0	0	0	4	2	0	3	2	1	3	1	4	20
Breach of contract	4	7	3	3	4	16	3	6	19	33	24	28	19	169
Breach of fiduciary duty	1	2	1	0	4	2	1	5	14	23	14	16	17	100
Good faith and fair dealing	0	1	0	0	2	5	0	1	3	9	11	7	12	51
Unjust enrichment	0	0	0	0	5	1	0	1	7	9	15	6	16	60
Negligent misrepresentation	0	1	0	0	4	2	0	3	8	41	27	28	24	138
Negligence	0	0	0	0	0	3	0	1	4	8	4	4	1	25
Illegal tax shelter	0	0	0	0	0	0	1	3	4	9	10	8	3	38
Total	15	20	12	10	32	60	25	42	88	200	165	138	160	967

[6] Ibid.
[7] Ibid

participants are likely to view the next round of innovative derivatives with greater skepticism—at least, one should hope so. If the litigation and enforcement process can curb the abuses that came to light during the recent crisis and promote better use of derivatives, then the capital markets can benefit from the resulting improvement in market efficiency. **A**

CONTACT THE AUTHORS:

John Finnerty and Sherry Chen

FOR MORE INFORMATION, CONTACT:

John Finnerty
Managing Director
+1 212 845 4090
jfinnerty@alixpartners.com

ABOUT US

In today's fast paced global market timing is everything. You want to protect, grow or transform your business. To meet these challenges we offer clients small teams of highly qualified experts with profound sector and operational insight. Our clients include corporate boards and management, law firms, investment banks, investors and others who appreciate the candor, dedication, and transformative expertise of our teams. We will ensure insight drives action at that exact moment that is critical for success. When it really matters. alixpartners.com