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MONITORING A GAME OF WINKS, NODS, AND RISK: DERIVATIVES REGULATION IN THE E.U. AND POLAND

*Robert F. Schwartz**

I. INTRODUCTION

A. Background

European Union regulators hailed legislative completion of the Financial Services Action Plan (FSAP) in mid-2004.¹ Announced in 1999, the FSAP covered forty-two measures designed to harmonize member states' approach to financial services and the capital markets.² Spurred by the introduction of the euro, the FSAP ultimately aimed to fashion a single financial market with low costs of capital, high returns on investment, and abundant sources of funding.³ Number one on the FSAP list of priorities for the formation of such a market was the formulation of common rules for integrated securities and derivatives markets.⁴

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¹ See Eur. Comm'n, Internal Mkt., Fin. Serv. Pol'y Group, *Tenth Progress Report: Turning the Corner, Preparing the Challenge of the Next Phase of European Capital Market Integration* (June 2, 2004) [hereinafter *Tenth Progress Report*], available at http://europa.eu.int/comm/internal_market/finances/docs/actionplan/index/progress10_en.pdf; compare with Eur. Comm'n, Internal Mkt., Fin. Serv. Pol'y Group, *Implementing the Framework for Financial Markets: Action Plan* (May 11, 1999) [hereinafter *FSAP*], available at http://europa.eu.int/comm/internal_market/finances/docs/actionplan/index/action_en.pdf (outlining the Commission's plan for a single financial market).

² See *FSAP*, *supra* note 1.

³ See *id.*; see also Niamh Moloney, *Time to Take Stock on the Markets: The Financial Services Action Plan Concludes as the Company Law Action Plan Rolls Out*, 53 INT'L & COMP. L.Q. 999 (2004).

⁴ See *FSAP*, *supra* note 1, at 5.

The high priority of derivatives regulation under the FSAP was not new; initial E.U. efforts to deal with derivatives date to the early 1990s.⁵ In 1995, faced with the spectacle of the Barings collapse,⁶ the European Parliament issued a resolution that recognized derivatives' crucial role in global markets. The European Parliament also stressed the need to address through legislation challenges generated by explosive growth in derivatives use.⁷ The Resolution requested that the European Commission create an agenda to update the Union's approach to derivatives and keep Parliament apprised of all developments.⁸ As part of its ongoing effort to fulfill the Resolution's assignment, the Commission drafted the FSAP.

Progress under the FSAP has been remarkable. By June 2004, lawmakers enacted thirty-nine of forty-two measures, including all derivatives-related measures. Although legislative efforts to complete the FSAP officially lasted through 2005, regulators in Europe turned their attention to FSAP implementation as early as 2004.⁹ Full implementation of derivatives-oriented provisions

⁵ See, e.g., Council Directive 92/49/EEC of 18 June 1992, On the Coordination of Laws, Regulations and Administrative Provisions Relating to Direct Insurance Other than Life Assurance and Amending Directives 73/239/EEC and 88/357/EEC, art. 21(1)(C)(iv), 1992 O.J. (L 228) 1; Council Directive 93/6/EEC of 15 Mar. 1993, The Capital Adequacy of Investment Firms and Credit Institutions, arts. 2(10), 4(1)(i), 4(5), 1993 O.J. (L 141) 27.

⁶ With regard to the breakdown of Barings, Rasiah Gengatharen notes:

On 27 February 1995 the British merchant bank, Barings Plc, was placed under administration due to massive losses incurred by its subsidiary, Barings Futures Singapore (BFS). These losses stemmed from the unauthorized trading activities of Nick Leeson, the General Manager of BFS, on the Singapore and Osaka Futures Exchange....Leeson was...able to take advantage of the lack of internal controls and supervision to conceal his losses from unauthorized trading.

RASIAH GENGATHAREN, DERIVATIVES LAW AND REGULATION 30–31 (1st ed. 2001).

⁷ Resolution on Parliament's Recommendations to the Commission Concerning a Legislative Proposal on Financial Derivatives: Their Present Role on Capital Markets, Their Advantages and Risks, 1995 O.J. (C 269) 217, available at <http://europa.eu.int/eur-lex/lex/LexUriServ/LexUriServ.do?uri=CELEX:51995IP0207:EN:HTML>.

⁸ *Id.* at 219.

⁹ See Press Release, Eur. Comm'n, Financial Services Action Plan: Good Progress but Real Impact Depends on Good Implementation (June 1, 2004), available

entails promoting unified standards for accounting, clearing and settlement, capital sufficiency, risk management, and market manipulation. As E.U. derivatives regulation shifts from drafting to implementation, questions arise regarding the new E.U. member states. How does the “new E.U. ten” measure up to current E.U. derivatives standards? In particular, how do the heavyweights—Poland, the Czech Republic, and Hungary—measure up?¹⁰

When the E.U. Parliament passed its 1995 derivatives resolution, the Polish, Czech, and Hungarian markets lacked any notable derivatives trading, exchange oriented or otherwise.¹¹ As the Commission released the FSAP in 1999, Hungary’s futures exchange was barely three years old; Poland’s futures market had existed for one year; and a Czech equivalent was still two years away from organization.¹² Although derivatives markets were up

at <http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/04/696&format=HTML&aged=0&language=EN&guiLanguage=en>.

¹⁰ See, e.g., Int’l Monetary Fund, World Economic Outlook Database, Sept. 2004, <http://www.imf.org/external/pubs/ft/weo/2004/02/data/>. IMF figures show that Poland, the Czech Republic, and Hungary dwarf their fellow E.U. entrants in terms of total GDP:

NEW E.U. TEN	GROSS DOMESTIC PRODUCT, CURRENT PRICES (IN BILLIONS, USD)			
	2001	2002	2003	2004
POLAND	186	191	209	230
CZECH REPUBLIC	61	74	90	103
HUNGARY	52	65	83	98
SLOVAKIA	21	24	33	40
SLOVENIA	20	22	28	33
LITHUANIA	12	14	18	22
CYPRUS	9	10	13	15
LATVIA	8	9	11	13
ESTONIA	6	7	9	11
MALTA	4	4	4	5

¹¹ See, e.g., Bank for Int’l Settlements, *Triennial Central Bank Survey: Foreign Exchange and Derivatives Market Activity in 2004*, at 19 (March 2005) [hereinafter *BIS Derivatives Survey 2004*], available at <http://www.bis.org/publ/rpfx05t.pdf>; Bank for Int’l Settlements, Monetary and Econ. Dep’t, *Triennial Central Bank Survey: Foreign Exchange and Derivatives Market Activity 1998*, at 19 (May 1999) [hereinafter *BIS Derivatives Survey 1998*], available at http://www.bis.org/publ/r_fx98finaltxt.pdf.

¹² See, e.g., Press Release, Prague Stock Exch., On 2nd August 2001, the Prague Stock Exchange, a. s., Obtained Permission to Organise Derivatives Trading (Mar. 8, 2001), <http://www.pse.cz/burza/default.asp?ka=323>; Ewa Krawczyk, *Rynek*

and running, Czech and Hungarian over-the-counter (OTC, i.e., non-exchange-traded) derivatives trading dipped precipitously in the period from 1998 to 2001 (see Fig. 1).¹³ More fundamentally, the capital markets of all three nations were notoriously illiquid.¹⁴

AVERAGE DAILY TURNOVER OF REPORTED OTC DERIVATIVES

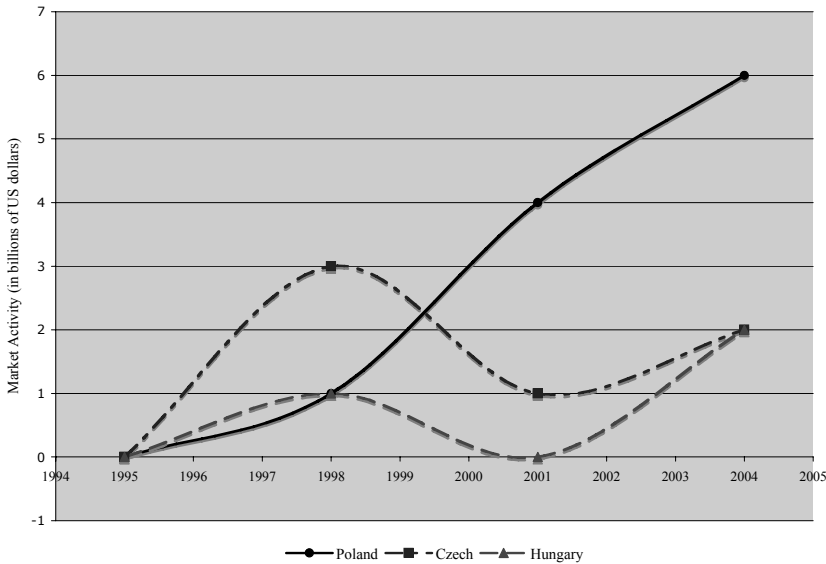


Fig. 1 (created by the author based on of BIS figures)

Despite such shaky first steps, the financial scene in Central and Eastern Europe has undergone rapid transformation, especially in Poland. Although recent press and scholarship suggest that the capital markets of Poland, the Czech Republic, and Hungary show

kontraktów terminowych czyli gra na przyszłość [The Market for Forward Contracts, or a Bet on the Future], BANKIER.PL, June 25, 2004, available at http://www.bankier.pl/wiadomosci/print.html?article_id=1166384; Budapest Stock Exchange, http://www.bse.hu/onlinesz/index_e.html (last visited Mar. 25, 2006).

¹³ *BIS Derivatives Survey 2004*, *supra* note 11, at 19; *BIS Derivatives Survey 1998*, *supra* note 11, at 19.

¹⁴ See, e.g., Zbigniew Kominek, *Stock Markets and Industry Growth: an Eastern European Perspective*, 36 APPLIED ECON. 1025, at 1026–27 (2004); ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *OECD ECONOMIC SURVEYS 2004: POLAND* 146 (June 2004) [hereinafter *OECD POLAND SURVEY*]; Ryszard Kokoszcyński & Andrzej Sławiński, *Poland's Vulnerability to Turbulence in the Financial Markets*, BIS POL'Y PAPERS (Nov. 1999), available at <http://www.bis.org/publ/plcy08h.pdf>.

signs of increased liquidity,¹⁵ derivatives-related developments in Poland merit special attention for two reasons.

First, Poland has experienced a steady increase in OTC derivatives trading. While Czech and Hungarian OTC derivatives trading dipped from 1998 to 2001, OTC derivatives trading has consistently risen in Poland since 1995 (see Fig. 1).¹⁶ In 2004, Poland's average daily turnover in reported OTC derivatives stood at \$6 billion; \$2 billion more than the Czech Republic and Hungary combined.

Second, the Warsaw Stock Exchange (WSE) is the largest in Eastern Europe.¹⁷ In the first quarter of 2005, the WSE posted the third highest number of initial public offerings (IPOs) in Europe after the London and Copenhagen exchanges.¹⁸ As one investment banker recently commented, "The Polish equity market is attractive...because it has depth and maturity with a number of liquid stocks, good daily turnover and a well developed derivatives market."¹⁹

As a key economic player among newly minted E.U. members, Poland demands a closer look. The region's quickly growing derivatives markets and increasingly liquid capital markets require analysis of E.U. derivatives regulation. In addition, an assessment

¹⁵ See, e.g., Kominek, *supra* note 14, at 1028–29; Kester Eddy, *Young Gun, Attila Szalay-Berzevicky: The New Face of the Budapest Stock Exchange*, BUS. HUNG., Sept. 2004, available at <http://www.businesshungary.com/september/trends01.html>.

¹⁶ *BIS Derivatives Survey 2004*, *supra* note 11, at 19; *BIS Derivatives Survey 1998*, *supra* note 11, at 19.

¹⁷ OECD POLAND SURVEY, *supra* note 14, at 146, 185. The OECD notes that 2003 WSE market capitalization almost equaled the combined value of the next three largest exchanges: Budapest, Prague, and Ljubljana. *Id.* In 2002, the WSE became the first exchange in Central and Eastern Europe to enter a cross-membership and cross-access agreement with the Euronext Stock Exchange (a merger of the Paris, Amsterdam, and Brussels exchanges). See *id.*; Péter Oszlay, *Marriage Plans: Budapest Stock Exchange Seeks Partners*, BUS. HUNG., Mar. 2002, available at http://www.amcham.hu/BusinessHungary/16-03/articles/16-03_26.asp. The Euronext link will help the WSE trim transaction costs for Western European traders who wish to tap the Polish market and help international firms with Eastern European operations to issue shares. OECD POLAND SURVEY, *supra* note 14, at 146.

¹⁸ See *Warsaw Stock Exchange Enjoys Third Largest Number of Debuts in Europe in Q1 2005*, POLAND BUS. NEWS, Apr. 1, 2005.

¹⁹ Press Release, Dresdner Kleinwort Wasserstein, DrKW Broadens Its Equities Platform to Offer Trading for Institutional Investor Clients in Polish Blue-chip Stocks and Derivatives (Feb. 16, 2005), available at http://www.drkw.com/eng/press/Archive_2005_2753.php; see also *Polish Market Proves a Draw*, INT'L SEC. FIN., Mar. 2005, available at <http://www.isfmagazine.com/default.asp?page=7&PubID=41&ISS=13004&SID=482111&ReturnPage=5>.

of Poland's performance in this pan-European regulatory framework should be reviewed. The key question is how well Poland has managed to implement FSAP-initiated measures for derivatives regulation.

B. Overview

The present article proposes to answer this question by providing an on-the-ground account of current developments in the Polish derivatives markets. In particular, this article will examine three vital areas of derivatives in the Polish market: market manipulation, close-out netting, and accounting standards. This article will pose practical questions in light of the legal framework of the E.U. derivatives regime.

Part II will briefly discuss the various types of derivatives and provides useful background for those unfamiliar with derivatives. Those who are familiar with derivatives, the International Swaps and Derivatives Association (ISDA), and their function in the financial markets should proceed directly to Part III.

Part III will give a concise overview of the historical and continuing development of European derivatives regulation. This Part will establish a basis for categorizing and comprehending such regulation.

Part IV will assess the efforts of Polish regulators to implement E.U. anti-manipulation, netting, and accounting norms in the context of derivatives. In addressing legal risk, this article argues that Polish legislators must update their bankruptcy statute to make it more equitable in close-out situations. Regarding market manipulation, this work contends that Polish regulators have not gone far enough in their efforts to combat manipulation on the Warsaw exchange. Polish prosecutors must enforce recently enacted, E.U.-influenced Polish laws prohibiting manipulation. Further, in the realm of derivatives accounting, Polish and E.U. regulators must limit the ability of publicly traded companies to hide financial risk by failing to reflect derivatives at fair market value on their balance sheets.

Part V will set forth conclusions.

II. WHAT ARE DERIVATIVES?

A. Fundamental Forms of Derivative Contract

1. Derivatives in general

As its name implies, a derivatives contract draws its value from some underlying asset (the “underlying”). The underlying can be physical (a commodity such as corn, steel, or oil) or financial (equity and debt securities, stock indexes, interest rates, currencies, or other derivatives). While simply describing derivatives poses little problem, defining them legally can be much more challenging. The regulator’s challenge is to avoid both over-inclusion and under-inclusion in the face of “an endless array of new products regularly introduced into the marketplace, many of which possess characteristics that do not easily fit into any established category of financial instruments.”²⁰ Nonetheless, even the most complex derivatives contract possesses one or both of two primary elements: a forward element and an option element.²¹

2. Forwards

A forward contract is an agreement that “obligates one counterparty to buy, and the other counterparty to sell, a specific underlying at a specific price, amount, and date in the future.”²² To use a physical example, Gillette might need a large amount of ethanol for use in its aftershave products. Since ethanol comes chiefly from corn, the price of ethanol varies with crop yields and other variables. Gillette wants a price that will preserve a favorable rate of return on its product; the ethanol producer wants the same thing.

To reduce risk, the two parties could enter into a contract that would allow both to fix the ethanol price in advance. Gillette, the buyer in this case, is taking a “long” position and the seller takes a “short” position. By selling forward, the ethanol producer places on

²⁰ GENGATHAREN, *supra* note 6, at 7.

²¹ *See, e.g., id.*

²² *Id.* at 13 (citing GLOBAL DERIVATIVES STUDY GROUP, DERIVATIVES: PRACTICES AND PRINCIPALS 30 (Group of Thirty 1993)); *see also* Kimberly D. Krawiec, *More Than Just a “New Financial Bingo”: A Risk-Based Approach to Understanding Derivatives*, 23 J. CORP. L. 1, at 9 (1997).

Gillette the risk that ethanol prices might go down. Through its long position, Gillette is able to shift the risk that ethanol prices might go up. The name for this mutual risk exchange is hedging; the symmetry of risk stands at the heart of forward agreements and distinguishes them from options.²³

3. Options

An option is the right to buy or sell a specific underlying asset at a specified price (strike price) on or before a specific future date.²⁴ A right to purchase the underlying—e.g., common stock—is a “call option” while a right to sell the underlying is a “put option.” If the price of the underlying moves favorably—above the strike price for a call and below the strike price for a put—the option holder can exercise the option and enjoy profits. If the price of the underlying moves unfavorably, the holder can choose not to exercise the option and has forfeited only the premium paid for the option. In other words, the option holder has a right but not the obligation to exercise the option.²⁵

The same does not hold true for the party who writes the option. The option writer possesses a legal obligation to buy—when the holder exercises her put—or sell—when the buyer exercises her call—the underlying. This fact stresses the asymmetrical risk of options. Whereas forward-based derivatives give rise to a symmetrical obligation in which the seller’s loss equals the buyer’s gain or vice versa, an option holder only ever forfeits the price of the option premium while the option writer’s loss is potentially unlimited.²⁶ Like forwards, options serve for hedging or speculation.²⁷

B. Exchange-traded Derivatives

Public exchanges provide forums of exchange for both forward- and option-based derivatives. Like any such trade, the benefit of

²³ See, e.g., GENGATHAREN, *supra* note 6, at 13; Krawiec, *supra* note 22, at 10.

²⁴ See, e.g., GENGATHAREN, *supra* note 6, at 17; Krawiec, *supra* note 22, at 11.

²⁵ See, e.g., GENGATHAREN, *supra* note 6, at 17–18; Krawiec, *supra* note 22, at 11–12.

²⁶ Krawiec, *supra* note 22, at 11–12.

²⁷ For a detailed explanation of how options can be used to hedge, see Krawiec, *supra* note 22, at 12; see, e.g., RICHARD A. BREALY & STEWART C. MEYERS, *PRINCIPLES OF CORPORATE FINANCE* 562 (McGraw-Hill 2003) (1981).

exchange-traded derivatives results from the efficiencies of a standardized contract. Parties do not need to dicker specially tailored terms regarding method of payment, time and place of delivery, the quality of the underlying, and so forth—price and quantity are the only subjects of negotiation. A future is a forward-based derivative that is exchange-traded and fully standardized in this manner. Standardization makes futures highly liquid.²⁸ High liquidity also characterizes exchange-traded options.

Futures exchanges possess peculiar mechanics. When a party either buys or sells a futures contract, the future price fixes immediately with payments made only after the contract reaches maturity. As a result, exchanges require parties to a futures contract to put up some collateral or “margin” in either the form of cash or some other highly liquid asset. Putting up collateral or “margin” demonstrates that parties have money to execute their side of the bargain. Another exchange peculiarity is “marking-to-market.” To mark their contract to market, each party calculates and accounts for any profits or losses on the contract.

Both of these mechanical aspects—margin and marking-to-market—require an exchange-designated clearinghouse to handle all of the back and forth between parties. The exchange’s clearinghouse requires payment for any losses and the exchange pays out any profits on a given contract. At the end of a trade, the parties perform a “clearance,” which is a basic recognition and calculation of all obligations under the trade. “Settlement” is the physical act of paying and receiving final payment under a mutual obligation. The European Commission’s Giovannini Report explained the mechanics thus:

The execution of derivatives trades typically takes place via direct members of exchanges, and the clearinghouse acts as central counterparty for all such trades. While clearing and settlement are simply post-execution stages in a securities transaction, clearing is the core process for the creation of an exchange-traded derivative. As the clearing process is integral to the very existence of a market for exchange-traded derivatives, the [central counterparty] plays a role that is analogous to a [central securities depository] in a securities

²⁸ See, e.g., Krawiec, *supra* note 22, at 10.

market. The market structures for exchange-traded derivatives have evolved very differently from those for the fixed income and equity markets.²⁹

C. Over-the-counter (OTC) Derivatives

1. Introduction: ISDA and the OTC markets

As of April 2004, the estimated daily global turnover in OTC derivatives totaled US\$3.5 trillion; the notional amounts—“sum of the nominal absolute value of all deals concluded and still open at the reference date”—stood at US\$221 trillion in June 2004.³⁰ About seventy-five percent of the outstanding notional amount seeks to control—or exploit—risks related to interest rates, and almost the entire balance centers on managing foreign-exchange exposure.³¹ In a poll of 386 major corporations across sixteen countries, seventy-three percent of respondents reported using derivatives to manage interest rate exposure and ninety-six percent used currency derivatives.³²

Most organizations that deal in privately negotiated, OTC derivatives belong to the International Swaps and Derivatives Association (ISDA), which currently numbers over 500 member institutions in over thirty countries.³³ Chartered in 1985, ISDA

²⁹ Eur. Comm'n Directorate Gen. for Econ. and Fin. Aff., *Economic Papers: The Giovannini Group, Cross-border Clearing and Settlement Arrangements in the European Union, November 2001*, 163, 21 (Feb. 2002) [hereinafter *Giovannini Report*], available at http://europa.eu.int/comm/economy_finance/publications/economic_papers/2002/ecp163en.pdf.

³⁰ *BIS Derivatives Survey 2004*, *supra* note 11, at 4, 15.

³¹ See, e.g., GENGATHAREN, *supra* note 6, at 23.

³² *Id.* at 20.

³³ See About ISDA, http://www.isda.org/wwa/wwa_nav.html (last visited Mar. 23, 2006); cf. Sean M. Flanagan, Student Article, *The Rise of a Trade Association: Group Interactions Within the International Swaps and Derivatives Association*, 6 HARV. NEGOT. L. REV. 211, 228 (2001). Flanagan relates:

As of January 2001, ISDA has over 500 member organizations; more than 200 of these are Primary Members, about 160 are Associate Members, and over 130 are Subscribers. The Primary Membership is composed of dealers and encompasses banks, securities companies, and large corporations from over thirty countries, including institutions such as Barclays; Chase Manhattan Bank; Credit Suisse First Boston International; Deutsche Bank AG; Enron Corporation; Sumitomo Bank Capital

emerged as an organization whose mission was to create and promote standardized documentation for derivatives at a time when even simple derivatives transactions had high transaction costs.³⁴ The first widely used ISDA documentation was the 1987 Master Agreement. The 1992 Master Agreement and the 2002 Master Agreement followed.³⁵ The Master Agreements set forth standardized, market-driven terms regulating general obligations of the parties, events of default, netting, early termination, transfer, currency provisions, and definitions.³⁶ If parties desire to modify any default provisions in the Master Agreement for their transaction, they may do so in an amending document called a “Schedule.”³⁷ The Master Agreement and Schedule, in turn, are given effect in “confirmations,” which are documents that serve as evidence of individual transactions under a Master Agreement, setting forth material terms such as interest rates/currency conversion rates, time to maturity of the transaction, and so forth.³⁸

One of the key benefits of using the ISDA Master Agreement is that once in place between two parties, all transactions entered into under the agreement constitute a single agreement.³⁹ Highlighting the practical benefit of a “single agreement” structure, Sean Flanagan explains:

Markets, Inc.; and Merrill Lynch & Co., Inc. The Associate Membership includes diverse professional firms and corporations such as Allen & Overy; the Chicago Mercantile Exchange; Cravath, Swaine & Moore; Euroclear; KPMG Peat Marwick, L.L.P.; Standard & Poor's; and QT Software AG. Subscribers include end-users of derivatives such as the African Development Bank; British Petroleum Company, P.L.C.; Ford Motor Credit Company; IBM Corporation; McDonald's Corporation; the Kingdom of Belgium; and Soros Fund Management, L.L.C.

Id.

³⁴ See About ISDA, *supra* note 33; *cf.* Flanagan, *supra* note 33, at 227–38.

³⁵ See ISDA Opinions and Documentation, <http://www.isda.org/docproj/ncdproj.html> (last visited Mar. 21, 2006).

³⁶ See INT'L SWAPS & DERIVATIVES ASS'N, ISDA 2002 MASTER AGREEMENT (2002) [hereinafter 2002 MASTER AGREEMENT]; INT'L SWAP DEALERS ASS'N, ISDA MASTER AGREEMENT (1992).

³⁷ See INT'L SWAPS & DERIVATIVES ASS'N, ISDA SCHEDULE TO THE 2002 MASTER AGREEMENT (2002); INT'L SWAPS & DERIVATIVES ASS'N, ISDA SCHEDULE TO THE MASTER AGREEMENT (1992).

³⁸ See Flanagan, *supra* note 33, at 230.

³⁹ 2002 MASTER AGREEMENT, *supra* note 36, at 1 (“All Transactions are entered into in reliance on the fact that this Master Agreement and all Confirmations form a single agreement between the parties...and the parties would not otherwise enter into any Transactions.”).

An end-user corporation and a swap dealer may exchange large numbers of confirmations over the course of several years, resulting in hundreds of simultaneous swaps between the parties. Without a master agreement, these swaps would require that the two parties exchange hundreds of payments at each swap payment date. The terms of the ISDA Master Agreement, however, can provide for netting the payments among all transactions made under the agreement between the parties (called “cross-transaction payment netting”). This reduces transaction costs since numerous swap payments are incorporated into a single payment.⁴⁰

Adding to the payment netting regime, the ISDA Master Agreement also provides for “close-out netting” that applies when one party to a transaction defaults or declares bankruptcy.⁴¹ Close-out netting allows the non-defaulting party to “calculate a single settlement amount by offsetting its scheduled future payment and delivery obligations to the bankrupt party against the bankrupt party’s obligations to it.”⁴² The practical benefit of a close-out netting arrangement is that it precludes a trustee or liquidator in bankruptcy from “cherry picking”—i.e., repudiating all trades that are out of the money for the bankrupt estate while insisting on performance of all trades that accrue to the estate’s benefit.⁴³

Among the ever-expanding universe of derivatives governed by the ISDA Master Agreement, plain vanilla swaps and forward rate agreements remain the most used derivatives.⁴⁴

2. Swaps and forward rate agreements

A swap is basically a series of forward transactions.⁴⁵ The need for a swap arises, for instance, when a company has incurred debt that carries a fixed interest rate and the debtor would prefer a floating rate. If a company with a fixed-rate liability can find a

⁴⁰ Flanagan, *supra* note 33, at 230–31.

⁴¹ See 2002 MASTER AGREEMENT, *supra* note 36, at 11–15.

⁴² Flanagan, *supra* note 33, at 231.

⁴³ S. Rory Derham, *Set-off and Netting of Foreign Exchange Contracts in the Liquidation of a Counterparty: Part 2, Netting*, 1991 J. BUS. L. 536, 537 (Nov. 1991).

⁴⁴ *BIS Derivatives Survey 2004*, *supra* note 11, at Annex II.

⁴⁵ Krawiec, *supra* note 22, at 10.

counterparty with floating-rate liabilities who wishes for the opposite, the parties can exchange interest payments during a negotiated contractual term. Practitioners refer to such transactions as fixed-for-floating interest-rate swaps, or simply “plain vanilla swaps.”⁴⁶ Alternatively, much of a company’s cash flow might be in the form of pesos but the company would prefer dollars. In such cases, the companies can enter into an analogous currency swap. Less used but also important are commodity and equity swaps. In most swap transactions—except for currency swaps—custom dictates that the parties do not exchange the notional principal, instead netting all interim payments.⁴⁷

A forward-rate agreement (FRA) arises in contexts where one party knows that at the end of period X it will need to incur short-term debt but worries that interest rates will rise in the interim. The FRA allows such parties to lock in the interest rates with a bank. Applying the same netting that applies in swaps, if interest rates are higher than the negotiated percentage rate at the end of period X, then the bank pays the difference. Likewise, if the interest rate is lower, the party owes the bank any difference.

III. E.U. STATUTORY FRAMEWORK FOR DERIVATIVES REGULATION

A. A General Framework of E.U. Derivatives Provisions

DERIVATIVES-RELATED E.U. STATUTES		
CATEGORY	STATUTE	YEAR
RISK MANAGEMENT	Council Directive 92/49/EEC of 18 June 1992, Relating to Direct Insurance Other than Life Assurance, 1992 O.J. (L 228) 1	1992
	Parliament and Council Directive 2000/12/EC of 20 March 2000, Relating to the Taking Up and Pursuit of the Business of Credit Institutions, Annex III, 2000 O.J. (L 126) 1, 52	2000
	Council Regulation 1346/2000 of 29 May 2000, On Insolvency Proceedings, 2000 O.J. (L 160) 1, arts. 4, 6 (EC)	2000

⁴⁶ See, e.g., GENGATHAREN, *supra* note 6, at 16–17.

⁴⁷ See, e.g., *id.*

CATEGORY	STATUTE	YEAR
RISK MANAGEMENT (CONT.)	Parliament and Council Directive 2001/108/EC of 21 Jan. 2002, Amending Council Directive 85/611 Relating to Undertakings for Collective Investment in Transferable Securities (UCITS), 2002 O.J. (L 41) 35	2002
	Parliament and Council Directive 2002/83/EC of 5 Nov. 2002, Concerning Life Assurance, 2002 O.J. (L 345) 1	2002
	Parliament and Council Directive 2004/39/EC of 21 Apr. 2004, On Markets in Financial Instruments, 2004 O.J. (L 145) 1	2004
SETTLEMENT AND CLEARANCE	Parliament and Council Directive 98/26/EC of 19 May 1998, On Settlement Finality in Payment and Securities Settlement Systems, 1998 O.J. (L 166) 45	1998
	Parliament and Council Directive 2000/12/EC of 20 Mar. 2000, Relating to the Taking Up and Pursuit of the Business of Credit Institutions, Annex III, 2000 O.J. (L 126) 1, 52	2000
	Parliament and Council Directive 2002/47/EC of 6 June 2002, On Financial Collateral Arrangements, 2002 O.J. (L 168) 43	2002
ACCOUNTING STANDARDS	Council Regulation 2223/96 of 25 June 1996, On the European System of National and Regional Accounts in the Community, 1996 O.J. (L 310) 1 (EC)	1996
	Commission Recommendation 2000/408/EC of 23 June 2000, Concerning Disclosure of Information on Financial Instruments and Other Items Complementing the Disclosure Required According to Council Directive 86/635/EEC on the Annual Accounts and Consolidated Accounts of Banks and Other Financial Institutions, 2000 O.J. (L 154) 36	2000

CATEGORY	STATUTE	YEAR
ACCOUNTING STANDARDS (CONT.)	Parliament and Council Regulation 2558/2001/EC of 3 Dec. 2001, Amending Council Regulation 2223/96 as Regards the Reclassification of Settlements Under Swaps Arrangements and Under Forward Rate Agreements 2001 O.J. (L 344) 1	2001
	Parliament and Council Regulation 1606/2002 of 19 July 2002, On the Application of International Accounting Standards, 2002 O.J. (L 243) 1	2002
	Commission Regulation 707/2004 of 6 Apr. 2004, Amending Regulation 1725/2003 Adopting Certain International Accounting Standards in Accordance with Regulation 1606/2002 of the European Parliament and of the Council, 2004 O.J. (L 111) 13 (EC)	2004
MARKET MANIPULATION	Parliament and Council Directive 2003/6/EC of 28 Jan. 2003, On Insider Dealing and Market Manipulation (Market Abuse), 2003 O.J. (L 96) 16	2003

Perhaps owing to the history and nature of exchange-traded derivatives, E.U. regulators have never seen fit to define them, leaving the task to individual exchanges. The first E.U. effort to grapple with a legislative definition of OTC derivatives came in 1993. In its Directive 93/6 of 15 March 1993, the Council provided:

[O]ver-the-counter (OTC) derivative instruments shall mean the interest-rate and foreign-exchange contracts referred to in Annex II to Directive 89/EC/EEC [amended by Annex III to Directive 2000/12/EC] and off-balance-sheet contracts based on equities, provided that no such contracts are traded on recognized exchanges where they are subject to daily margin requirements and, in the case of foreign-exchange contracts, that every such

contract has an original maturity of more than 14 calendar days.⁴⁸

Annex III to Directive 2001/12 enumerates a long list of derivatives contracts, including single-currency interest-rate swaps, basis-swaps, forward-rate agreements, interest-rate futures, interest-rate options, and many variations on such contracts.⁴⁹ Although such a definition appears prescriptive, the Council in fact left the field of possible derivative contracts wide open, recognizing all “other contracts of a similar nature.”⁵⁰

Upon initial consideration, the development of E.U. derivatives norms seems both disparate and diffuse—spread out over more than a decade. One first recognizes that twice as many derivatives-related provisions appeared in the five years following announcement of the FSAP as did in the seven years preceding. Indeed, the categories and guidelines contained in the FSAP allow one to sort E.U. derivatives legislation into four broad categories: risk management, clearance and settlement, accounting, and market manipulation.⁵¹

⁴⁸ Council Directive 93/6/EEC, *supra* note 5, art. 2(10), at 1, 4.

⁴⁹ Parliament and Council Directive 2000/12/EC of 20 March 2000, Relating to the Taking Up and Pursuit of the Business of Credit Institutions, Annex III, 2000 O.J. (L 126) 1, 52.

⁵⁰ *Id.*

⁵¹ The key risk-management provisions include: Council Directive 92/49/EEC, *supra* note 5; Parliament and Council Directive 2000/12/EC of 21 Jan. 2002, *supra* note 49; Council Regulation 1346/2000 of 29 May 2000, On Insolvency Proceedings, 2000 O.J. (L 160) 1 (EC); Parliament and Council Directive 2001/108/EC of 21 Jan. 2002, Relating to Undertakings for Collective Investment in Transferable Securities, 2002 O.J. (L 41) 35; Parliament and Council Directive 2002/83/EC of 5 Nov. 2002, Concerning Life Assurance, 2002 O.J. (L 345) 1; Parliament and Council Directive 2004/39/EC of 21 Apr. 2004, On Markets in Financial Instruments, 2004 O.J. (L 145) 1.

For provisions relating to settlement and clearance: Parliament and Council Directive 98/26/EC of 19 May 1998, On Settlement Finality in Payment and Securities Settlement Systems, 1998 O.J. (L 166) 45; Parliament and Council Directive 2000/12/EC, *supra* note 49; Parliament and Council Directive 2002/47/EC of 6 June 2002, On Financial Collateral Arrangements, 2002 O.J. (L 168) 43.

To see E.U. provisions on accounting standards, consult: Council Regulation 2223/96 of 25 June 1996, On the European System of National and Regional Accounts in the Community, 1996 O.J. (L 310) 1 (EC); Commission Recommendation 2000/408/EC of 23 June 2000, Concerning Disclosure of Information on Financial Instruments and Other Items Complementing the Disclosure Required According to Council Directive 86/635/EEC on the Annual Accounts and Consolidated Accounts of Banks and Other Financial Institutions, 2000 O.J. (L 154) 36; Parliament and Council

Prerequisite to grasping the E.U. regime of derivatives provisions, one must appreciate the practical difference between directives and regulations. Regulations are binding statutory measures—binding as to both ends and means—directly applicable to all member states.⁵² “The phrase ‘directly applicable’...signifies that regulations are taken to be part of the national legal systems automatically, without the need for separate national legal measures.”⁵³ In the wake of a regulation, an E.U. member state might need to modify its law to effect compliance.

Directives, in distinction, are binding only with regard to their end purpose. Directives give member states legislative leeway in choosing the form and method of implementation. Another key difference between directives and regulations is that directives must be “notified to the person to whom they are addressed.”⁵⁴ “Directives are particularly useful when the aim is to harmonize the laws within a certain area or to introduce complex legislative change.”⁵⁵ Thus, given the “complex changes” occasioned by efforts to harmonize member states’ derivatives regulations, it is little surprise that most E.U. derivatives provisions are directives. This is true of risk management harmonization.

B. Risk Management

1. Market, counterparty, and other risks

The seminal initiatives that require companies and central banks to manage derivatives-related risk come from the Basle Committee on Banking Supervision.⁵⁶ The Basle Committee

Regulation 2558/2001/EC of 3 Dec. 2001, Regarding the Reclassification of Settlements Under Swaps Arrangements and Under Forward Rate Agreements 2001 O.J. (L 344) 1; Parliament and Council Regulation 1606/2002 of 19 July 2002, On the Application of International Accounting Standards, 2002 O.J. (L 243) 1 (EC); Commission Regulation 707/2004 of 6 Apr. 2004, Amending Regulation 1725/2003 Adopting Certain International Accounting Standards in Accordance with Regulation 1606/2002 of the European Parliament and of the Council, 2004 O.J. (L 111) 3 (EC).

For the E.U. statute on market manipulation, consult Parliament and Council Directive 2003/6/EC of 28 Jan. 2003, On Insider Dealing and Market Manipulation (Market Abuse), 2003 O.J. (L 96) 16.

⁵² PAUL CRAIG & GRÁINNE DE BÚRCA, *EU LAW: TEXTS, CASES, AND MATERIALS* 112–14 (Oxford 2003).

⁵³ *Id.* at 113.

⁵⁴ *Id.* at 114.

⁵⁵ *Id.* at 115.

⁵⁶ *See, e.g.*, GENGATHAREN, *supra* note 6, at 62.

released its *Risk Management Guidelines for Derivatives* in 1996 (Basel Guidelines).⁵⁷ The Basle Guidelines enumerate five fundamental risks: credit and settlement risk (counterparty's failure to perform under an obligation), market risk (risk stemming from exogenous factors such as interest rate and currency rate movements), liquidity risk (inability to offset a derivatives position with a matching position in an illiquid market), operations risk (human error and information systems failure), and legal risk (unenforceability of a contract).⁵⁸ The culmination or simultaneous realization of these risks is often termed "systemic risk."⁵⁹

Awareness of these risks has been reflected in derivatives regulations the world over, including regulations in the E.U. In the FSAP, the Commission resolved to present proposals that would maintain high standards of banking, insurance, and securities legislation. To this end, taking into account the work of existing bodies is helpful when possible (Basle Committee, FESCO, etc.).⁶⁰

The first E.U. provision to deal with an aspect of derivatives risk management antedated both FSAP and Basle guidelines. In Directive 92/49/EEC, the Council stated that where insurance companies use derivatives, member states must ensure that: "derivative instruments...may be used in so far as they contribute to a reduction of investment risks or facilitate efficient portfolio management. They must be valued on a prudent basis and may be taken into account in the valuation of the underlying assets."⁶¹ Hinting at the substance of regulations to come, the Council's approach in Directive 92/49 evidenced concern that the market risk associated with so-called "speculative derivatives use" might endanger the cash flow and reserves of insurance providers. As a result, E.U. regulators restricted insurance companies' permitted use of derivatives to hedging activities.

⁵⁷ BANK FOR INT'L SETTLEMENTS, BASEL COMMITTEE: RISK MANAGEMENT GUIDELINES FOR DERIVATIVES (July 1994), available at <http://www.bis.org/publ/bcbasc211.htm>.

⁵⁸ *Id.*

⁵⁹ Krawiec, *supra* note 22, at 51.

⁶⁰ FSAP, *supra* note 1, at 14.

⁶¹ Council Directive 92/49/EEC, *supra* note 5, art. 21(C)(iv), at 13. In addition, Parliament and Council Directive 2002/83/EC, *supra* note 51, provides in nearly identical terms that life insurance companies can only use derivatives to hedge.

The “hedging only” standard still proved it insufficient to solve the problem of speculative derivative use.⁶² Investors entered into derivative securities contracts that—to the negligently or willfully uninformed—appeared risk free, but which turned out to be highly leveraged instruments.⁶³ Hedging exercises turned into debacles. As a result, the E.U. in a post-Barings, post-Parmalat, post-FSAP world shifted its focus and enacted more specific provisions that gave parties less room to “fudge.”

For instance, beyond imposing a restriction on insurance fund managers to use derivatives only for hedging, post-FSAP provisions impose a duty on brokers to ascertain the sophistication and risk profile of their customers:

[Investment firms] shall obtain the necessary information regarding the client’s or potential client’s knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives so as to enable the firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him.⁶⁴

More examples of prescriptive rules aimed at minimizing risk arise in Directive 2001/108, amending an earlier directive on Undertakings for Collective Investment in Transferable Securities (UCITS).⁶⁵ The Parliament and the Council addressed UCTIS to investment and hedge funds of all stripes.⁶⁶ Adding to the binding

⁶² See, e.g., GENGATHAREN, *supra* note 6, at 19 (noting the loss of hundreds of millions of dollars through use of structured notes that seemed fit for hedging); FRANK PARTNOY, F.I.A.S.C.O.: THE INSIDE STORY OF A WALL STREET TRADER 55–61 (Penguin Books 1999) (relating Morgan Stanley’s sale of principal exchange rate linked securities (PERLS) seemingly benign derivatives that were involved in many customer losses).

⁶³ See, e.g., GENGATHAREN, *supra* note 6, at 19.

⁶⁴ Parliament and Council Directive 2004/39/EC, *supra* note 51, ch. 2, § 2, art. 19(4), at 17.

⁶⁵ Parliament and Council Directive 2001/108/EC, *supra* note 51, Preamble, at 36.

⁶⁶ Council Directive 85/611/EEC of Dec. 1985, On the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities, art. 1(2), 1985 O.J. (L 375) 3. Article 1(2) reads:

obligation of brokers to assess customer risk tolerance, UCITS provides that parties to an OTC derivatives transaction must conduct ongoing assessment of their liquidity and market risk exposure. Taken together, post-FSAP risk-management directives give member states guidance aimed at more full integration of the Basle standards into national law.

2. Legal risk: setoff and netting

As mentioned in the discussion of close-out netting under an ISDA Master Agreement, a major risk in the derivatives setting is the possibility that a bankruptcy administrator will selectively try to enforce only those trades that are beneficial to the estate, in other words, to cherry pick.⁶⁷ Although the close-out netting provisions of the Master Agreement attempt to deal with this legal risk, the chance remains that a transaction might be subject to the laws of a jurisdiction that does not recognize close-out netting.

The E.U. addresses this problem within its own borders in its Insolvency Regulation.⁶⁸ The Article 4(2) of the Insolvency Regulation sets forth a general rule that: “The law of the State of the opening of proceedings shall determine...the conditions under which set-offs may be invoked.”⁶⁹ In the bankruptcy context, a set-off is generally the right of a creditor to reduce obligations owed by the bankrupt party—typically an unpaid debt—by an amount that the creditor owes the bankrupt party—typically a deposit of the bankrupt party.⁷⁰ Set-off, although related, is substantively different

2. For the purposes of this Directive, and subject to Article 2, UCITS shall be undertakings:

—the sole object of which is the collective investment in transferable securities of capital raised from the public and which operate on the principle of risk-spreading, and

—the units of which are, at the request of holders, re-purchased or redeemed, directly or indirectly, out of those undertakings’ assets. Action taken by a UCITS to ensure that the stock exchange value of its units does not significantly vary from their net asset value shall be regarded as equivalent to such re-purchase or redemption.

Id.

⁶⁷ See Derham, *supra* note 43, at 537.

⁶⁸ Council Regulation 1346/2000, *supra* note 51. The Insolvency Regulation has been of direct application in the E.U. since May 31, 2002. *Id.*

⁶⁹ *Id.*

⁷⁰ See, e.g., 11 U.S.C. § 553 I(A) (2005).

from close-out netting because it involves the reduction of one mutual obligation. By contrast, close-out netting involves the reduction of an unlimited number of obligations—with varying amounts and maturities—to produce one sum that itself might be subject to set-off. Because the drafters of the Insolvency Regulation do not distinguish between set-off and netting—a distinction that was drawn in at least one later E.U. statute⁷¹—it seems that the drafters conflated the two, making the application of both close-out netting and set-off subject to the laws of each member state law.

The general rule of Insolvency Regulation Article 4(2) dictates that if the law of a given member state prohibits set-offs altogether and a counterparty declares insolvency in that jurisdiction, the non-bankrupt counterparty in a derivatives transaction is subject to cherry picking, thus preventing the execution of close-out netting or the enjoyment of set-off rights. To counterbalance such situations, E.U. legislators included Article 6(1), which provides that: “The opening of insolvency proceedings shall not affect the right of creditors to demand the set-off of their rights against the claims of the debtor, where such a set-off is permitted by the law applicable to the insolvent debtor’s claim.”⁷² Thus, as long as parties select netting and set-off-friendly jurisdictions to govern their ISDA Master Agreements (such as New York or the U.K.), the ability of member state bankruptcy administrators to cherry pick is muted by the Insolvency Regulation.

C. Clearance and Settlement

Two initial pieces of E.U. legislation addressed the topic of clearance and settlement—Directive 98/26 and Directive 2000/12. In subsequent legislation, Parliament remarked: “Directive 98/26...constituted a milestone in establishing a sound legal framework for payment and securities settlement systems. Implementation of that Directive has demonstrated the importance of limiting systemic risk...and the benefits of common rules in relation to collateral constituted to such systems.”⁷³ Despite the

⁷¹ Parliament and Council Directive 2001/24/EC of 4 Apr. 2001, On the Reorganisation and Winding Up of Credit Institutions, 2001 O.J. (L 125) 15, art. 25 (“Netting agreements shall be governed solely by the law of the contract which governs such agreements.”).

⁷² Council Regulation 1346/2000, *supra* note 51, at 6.

⁷³ Parliament and Council Directive 2002/47/EC, *supra* note 51, Preamble, at 43.

changes affected by these initial two directives, settlement systems in the E.U. remained fragmented and the market suffered under resulting inefficiencies.⁷⁴ The European Commission appointed the Giovannini Group to help resolve this issue.

The Giovannini Group, led by Dr. Alberto Giovannini, formed in 1996 to advise the European Commission on issues “relating to EU financial integration and the efficiency of euro-denominated financial markets.”⁷⁵ In February 2002, the Group issued a report on cross-border clearing and settlement arrangements. The Group stated: “The existing infrastructure for the provision of clearing and settlement services in the European Union is the product of a fragmented securities market...[T]he additional cost and risk associated with this fragmentation represents a significant limitation on the scope for cross-border securities trading in the European Union.”⁷⁶

In an effort to improve the system, the Group identified key market barriers that separated the settlement systems of member countries—technology barriers, differences in user agreements and market conventions—and encouraged a market-led convergence to common standards.⁷⁷ Recognizing that perverse incentives might prevent market change, the Group accepted that E.U. intervention might be required.⁷⁸ In the end, the Giovannini Report found more fragmentation in the settlement system for securities than for derivatives markets.⁷⁹

On June 6, 2002, the European Parliament and the Council issued Directive 2002/47 on financial collateral arrangements. The Parliament and Council tailored Directive 2002/47 to require use of “a central counterparty, settlement agent or clearing house” in

⁷⁴ *Giovannini Report*, *supra* note 29, at 19.

⁷⁵ *Id.* at 1.

⁷⁶ *Id.* at 20.

⁷⁷ *Id.* at 59–60.

⁷⁸ *Id.* at 60. Commenting in this regard, the Group wrote: “Such intervention could prove unavoidable as a means to overcome national sensitivities and/or the perverse incentives that exist for entities that profit by arbitraging inefficiencies in cross-border clearing and settlement.” *Id.* at 67.

⁷⁹ *Id.* at 7–19. The Group linked greater fragmentation in cross-border securities settlement to the greater number of actors and thus greater complexity in a typical cross-border securities transaction. *Id.*

exchange-traded derivatives transactions to lessen the effects of cross-boarder fragmentation.⁸⁰

D. Accounting

The current story of derivatives accounting in the E.U. is the story of International Accounting Standard (IAS) 39. In July 2002, the Parliament and the Council issued a regulation that mandated obligatory application of International Financial Reporting Standards (IFRS) as of January 1, 2005.⁸¹ Notably—like its law on insolvency proceedings—the E.U. instituted this measure using a regulation and not a directive.

On December 1, 2004, a reporter noted:

Few businesses...are as disgruntled with IFRS as the banks and financial institutions. This is because of a clause called IAS 39, which requires them to record a range of financial instruments, such as derivatives and bonds, at fair value on the balance sheet. Any changes in the value of these instruments must then be fed through the company's income statement, or

⁸⁰ Parliament and Council Directive 2002/47/EC, *supra* note 51, art. 1(2)(d). In Parliament and Council Directive 98/26/EC, art. 2, the European Parliament and the Council defined the main terms as follows:

(c) 'central counterparty' shall mean an entity which is interposed between the institutions in a system and which acts as the exclusive counterparty of these institutions with regard to their transfer orders;

(d) 'settlement agent' shall mean an entity providing to institutions and/or a central counterparty participating in systems, settlement accounts through which transfer orders within such systems are settled and, as the case may be, extending credit to those institutions and/or central counterparties for settlement purposes;

(e) 'clearing house' shall mean an entity responsible for the calculation of the net positions of institutions, a possible central counterparty and/or a possible settlement agent;

Parliament and Council Directive 98/26/EC, *supra* note 51, art. 2.

⁸¹ Parliament and Council Regulation 1606/2002, *supra* note 51.

else shown in shareholders' equity, depending on the instrument. The impact could be big, given that, until recently, many financial assets and liabilities have been recorded at historical cost rather than fair value, or else not recorded on the balance sheet at all.⁸²

As indicated, the centerpiece of IAS 39 is greater use of fair value for all financial instruments.⁸³ The International Accounting Standards Board stated: "Under this standard, all financial assets and financial liabilities should be recognized on the balance sheet, including all derivatives.... Subsequent to initial recognition, all financial assets should be remeasured to fair value."⁸⁴

For exchange-traded derivatives, fair value is simply the market value of a future or option at any given time.⁸⁵ Upon creation of a new balance sheet, all public companies with exchange-traded derivatives positions must mark the derivatives to market as either current assets or current liabilities. But what of OTC derivatives? What is the value of a contract that might not have any corresponding liquid market? In such situations, the first line of defense is to assess whether a materially similar, already-priced instrument exists.⁸⁶ When this fails, a party can apply discounted cash flow analysis or employ an approved option pricing model.⁸⁷ Derivatives must be on the balance sheet and represented by some measurement of fair value—unless, as it turns out, an exception applies.

As the date of IFRS compliance drew near, the Commission issued Regulation 707/2004 detailing how companies could comply with IFRS.⁸⁸ The new Regulation contained a carve-out that applied to derivatives used in certain types of hedging transactions.⁸⁹ The carve-out began by stating: "An entity shall not reflect in its...balance sheet a hedging relationship...that does not qualify for

⁸² *When Fair's Fair*, BUS. EUR., Dec. 2004, at 2 (article available with Author upon request).

⁸³ INT'L ACCT. STANDARDS BD., INTERNATIONAL FINANCIAL REPORTING STANDARDS 39-5 (2003) [hereinafter INT'L FIN. REPORTING STANDARDS].

⁸⁴ *Id.* at 39-6.

⁸⁵ *Id.* at 39-50.

⁸⁶ *Id.* at 39-51.

⁸⁷ *Id.*

⁸⁸ Commission Regulation 707/2004, *supra* note 51.

⁸⁹ *Id.* at 10.

hedge accounting under IAS 39.”⁹⁰ The provision then proceeded to list transactions where derivatives would be exempt, including: “many hedging relationships where the hedging instrument is a cash instrument or written option; where the hedged item is a net position; or where the hedge covers interest risk in a held-to-maturity investment.”⁹¹ Explaining this otherwise baffling exemption, Jane Fuller writes for the *Financial Times*:

IAS39...has been seriously compromised by objections, notably from French banks. They dislike the way traditional hedging practices are excluded from the hedge accounting definitions. As a result, the European parliament has bowed to business pressure and allowed “carve-outs”...from the mark-to-market requirements. The ability to compare companies across borders has been diluted and a dangerous precedent has been set that political pressure can force changes to standards that are supposed to be set independently.⁹²

Thus, while adopting IAS 39 was a step in the right direction, its E.U. implementation has yet to show whether the carve-out will compromise the crucial underlying aim of more accurately reflecting all the liabilities—and assets—of publicly traded institutions.

E. Market Manipulation

Of the numerous E.U. regulations on derivatives, only one deals directly with market manipulation.⁹³ Directive 2003/6 applies to, among others, exchange-based derivatives trades. Instead of enumerating all possible forms of manipulation, the Directive adopts a broad definition that accords member states power to pierce manipulative practices in a substance-over-form manner. Article 1(2)(a) provides that market manipulation means:

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² Jane Fuller, *Does Europe's Accounts Overhaul Add Up?*, FT.COM, Nov. 22, 2004 (Westlaw).

⁹³ Parliament and Council Directive 2003/6/EC, *supra* note 51.

[T]ransactions or orders to trade: [i] which give, or are likely to give, false or misleading signals as to the supply of, demand for or price of financial instruments, or [ii] which secure, by a person, or persons acting in collaboration, the price of one or several financial instruments at an abnormal or artificial level, unless the person who entered into the transactions or issued the orders to trade establishes that his reasons for so doing are legitimate and that these transactions or orders to trade conform to accepted market practices on the regulated market concerned.⁹⁴

In a classic move of “minimum harmonization,” the Parliament and Council made clear that member states should impose administrative sanctions against any who violate the anti-manipulation provisions, but likewise stressed that member states were free to impose extra criminal sanctions.⁹⁵ “Member States shall ensure that these measures are effective, proportionate and dissuasive.”⁹⁶

IV. IMPLEMENTING E.U. DERIVATIVES LEGISLATION IN POLAND

A. The Polish Derivatives Markets and Optimal Enforcement Efforts

Despite E.U. legislators’ enactment of provisions to regulate four key aspects of derivatives trading, the European Commission cautioned that “[r]egulation alone does not deliver an integrated single market. The extent to which the FSAP will contribute to...a truly European market...now depends on the consistent and timely implementation of the FSAP measures at Member State level, convergence of national supervisory practices and rigorous enforcement.”⁹⁷

As E.U. and local officials promote and enforce derivatives regulations in new member states, questions arise such as where should they spend their efforts, which endeavors will carry the most

⁹⁴ *Id.* art. 1(2)(a), at 20.

⁹⁵ *Id.* art. 14(1), at 23.

⁹⁶ *Id.*

⁹⁷ *Tenth Progress Report, supra* note 1.

utility, and what level of enforcement is optimal? One category—settlement and clearance—although crucial to the fluid operation of derivatives markets, does not require special government enforcement action in the new member states. However, other categories represent areas where E.U. and member state activism can effect further change.

Government officials should not spend their efforts concentrating on derivatives settlement and clearance. As a primary matter, the Giovannini report found less fragmentation—and thus less risk of inefficiency in the European markets—where futures settlement and clearance was concerned.⁹⁸ For futures transactions, the E.U. simply mandates that all exchanges use a central counterparty. Poland, the Czech Republic, and Hungary all have central counterparties that meet E.U. standards, and thus the work of would-be enforcers is complete.

The management of market, credit, operational, and liquidity risk is crucially important for the end-users of derivatives contracts. Although the prevalence of discrete derivatives-related risks varies across markets, the principles of risk management hold constant whether the parties are in London, Frankfurt, Prague, or Warsaw. However, to the extent that markets such as Poland, the Czech Republic, and Hungary might pose greater counterparty risk, market risk, or other such Basle-identified risks, European or local officials have limited capacity to minimize the risk. European and Polish legislatures took the important step of promulgating specific norms, and now the task lies in the hands of market participants to carefully follow sound practices as they enter into and service their derivatives contracts. Most solutions to market, counterparty, liquidity, and other risks will have to be market solutions, not solutions dictated or enforced from a central authority.

One notable exception to this rule lies in market manipulation, which embody hazards that require the attention of local and E.U. regulators. Market manipulation is a prime concern in new member states due to the size of Eastern European exchanges, which—despite recent progress—are significantly smaller and less liquid than leading exchanges in London, Frankfurt, and other financial centers. Recent corporate finance literature confirms that manipulation occurs much more often when exchanges are

⁹⁸ *Giovannini Report*, *supra* note 79, at 7–19.

relatively small, illiquid, and volatile.⁹⁹ Underscoring this reality, the WSE has experienced recent instances of futures-trading manipulation. Since manipulation tends to be easier in smaller markets, E.U. market-manipulation provisions are a prime concern at the local level, particularly for local prosecutors.

In like manner, the legal risk stemming from a specific provision of the Polish Bankruptcy Law of 2003 makes it possible that, despite the E.U. Insolvency Regulation, parties to an ISDA Master Agreement who have chosen Polish law as the law governing their trades could be subject to cherry picking by Polish bankruptcy administrators.¹⁰⁰ Polish legislators must be aware of this risk and work to counteract the possible inequitable effects created by the bankruptcy statute.

Whereas market manipulation and close-out netting pose special problems for Poland and other Eastern European markets, derivatives accounting standards pose a general problem for all E.U. member states. The carve-out introduced by European legislators into IAS 39 has such broad application that it threatens to swallow the rule that companies must reflect all derivatives liabilities on their balance sheets. In light of recent derivatives-related accounting scandals in the United States, European and member-state regulators would do well to carefully scrutinize how

⁹⁹ See Rajesh K. Aggarwal and Guojun Wu, Student Article, *Stock Market Manipulation—Theory and Evidence*, 79 J. BUS. (forthcoming 2006) (manuscript at 22–24, available at http://www.afajof.org/pdfs/2004program/UPDF/P306_Asset_Pricing.pdf). In the context of American markets, Rajesh Aggarwal and Guojun Wu explain:

For example, 47.89% of all manipulation cases happen in the over-the-counter markets such as the OTC Bulletin Board and the Pink Sheets, and 33.81% of the cases happen in either regional exchanges or unidentified markets. About 17% of the cases occur on the NYSE, AMEX, or Nasdaq National Market combined. Overall, the OTC Bulletin Board, the Pink Sheets, and the regional exchanges are relatively inefficient in the sense that they are small and illiquid...Our results show that about over 50% of the stocks manipulated are “penny stocks” with very low average trading volume and market capitalization.

Id. See also Paul G. Mahoney et al., *Market Manipulation: A Comprehensive Study of Stock Pools*, 77 J. FIN. ECON. 147–70 (2005), available at <http://www.science-direct.com> (requires password).

¹⁰⁰ Ustawa z dnia 28 lutego 2003 r. Prawo upadłościowe i naprawcze [Statute of Feb. 28, 2003 on the Law of Bankruptcy and Workouts], Dz.U 2003 nr. 60 poz. 535 [hereinafter Polish Bankruptcy Law].

companies are accounting for their derivatives contracts. To the extent that financial managers in Poland—or anywhere else—can exclude derivatives from the balance sheet or record them at historical cost, they can hide risk and potentially place investor welfare on the altar of smooth earnings. The following subsections will first discuss market manipulation, followed by accounting standards.

B. Market Manipulation on the Polish Futures Exchange

1. Background and the “100 second” scandal

Futures trading on the WSE began in 1998, and futures represent the quickest growing sector of the WSE.¹⁰¹ The exchange makes it possible for investors to trade futures in euros, U.S. dollars, Polish treasury bonds, and certain WSE-listed stocks. In 2003, the WSE recorded 4.2 million futures trades, representing an increase of approximately 1 million from the previous year.¹⁰² Although developing robustly, the Warsaw futures exchange pales in comparison to world exchanges such as the Korea Futures Exchange—2.5 billion trades in 2004—or the Eurex—1.1 billion trades in 2004.¹⁰³ Most futures trades on the WSE—some ninety-eight percent—take place on the exchange’s “WIG 20,” which is an index of the WSE’s twenty blue-chip listed companies.¹⁰⁴

WSE options trading is not as mature as its futures counterpart, having only started operation on September 22, 2003.¹⁰⁵ The WSE created its options exchange to complement its offering of derivatives that have the WIG 20 as their underlying asset.

One Polish observer recently commented: “The [exchange-traded] market for forward contracts, especially futures trading on the WIG 20, can be acknowledged as developed. Confirming this

¹⁰¹ Krawczyk, *supra* note 12.

¹⁰² Press Release, Warsaw Stock Exchange, *Instrumenty pochodne w roku 2003—podsumowanie* [Derivatives in the Year 2003—A Summary] 1–3 (Jan. 9, 2004) [hereinafter *Derivatives Press Release*], available at <http://www.gpw.com.pl/zrodla/gpw/pdf/090104opcje.pdf>.

¹⁰³ Galen Burghardt, *FIA Annual Volume Survey: The Invigorating Effects of Electronic Trading*, *FI MAG.*, Mar./Apr. 2005, available at <http://www.futuresindustry.org/fimagazi-1929.asp?a=1026>.

¹⁰⁴ Derivatives Press Release, *supra* note 102, at 1.

¹⁰⁵ Warsaw Stock Exchange, *Opcje na GPW* [Option Contracts on the WSE] (2003), available at http://www.gpw.com.pl/zrodla/gpw/pdf/artykul_opcje19.pdf.

fact are not only statistical data, but also the scandals that have begun to accompany such contracts.”¹⁰⁶ The most prominent scandal in relation to WIG 20 futures trading took place on February 4, 2004.¹⁰⁷

Near the end of the day’s trading session, an investor from the Virgin Islands placed a number of large sell orders in quick succession through its broker.¹⁰⁸ The sell orders set off an avalanche of stop orders—standing instructions from an investor in a futures trade to its broker not to sell below a certain price in order to hedge against losses—and the futures price fell 108 trading points.¹⁰⁹ Seconds later, as if anticipating the drop, the same broker placed a string of buy orders and the price spiked upward roughly 260 points as other investors piled on.¹¹⁰ When the dust settled one hundred seconds later, 307 investors had made PLN 5.4 million, 777 investors had lost PLN 5.4 million, and the Virgin Islands investor netted PLN 2.6 million.¹¹¹ One reporter noted that some individual investors lost all of the money in their margin accounts, forcing them to leave the exchange altogether.¹¹² Investors began to refer to the incident as the WSE’s “notorious 100 seconds.”¹¹³

Commentators dubbed the matter one of the greatest scandals in WSE history,¹¹⁴ and they expressed fears about what such manipulation could mean for overall investment:

¹⁰⁶ Krawczyk, *supra* note 12.

¹⁰⁷ See *id.*; see also Marcin Dziadkowiak, Komentarz redakcyjny, *Środa na GPW czyli 2,5 mln zł do wzięcia* [Editorial, *Wednesday on the WSE, or PLN 2.5 Million for the Taking*], BANKIER.PL, Feb. 4, 2004, available at http://bankier.pl/wiadomosci/print.html?article_id=1013441; Miłosz Węglewski, *100 sekund szaleństwa na kontraktach terminowych* [100 Seconds of Insanity on the Futures Exchange], GAZETA WYBORCZA, Feb. 5, 2004, available at <http://serwisy.gazeta.pl/metroon/1,0,1900550.html>.

¹⁰⁸ See Dziadkowiak, *supra* note 107; Węglewski, *supra* note 107.

¹⁰⁹ See *id.*; Krawczyk, *supra* note 12.

¹¹⁰ See Dziadkowiak, *supra* note 107.

¹¹¹ See Krawczyk, *supra* note 12.

¹¹² See Węglewski, *supra* note 107.

¹¹³ Paweł Pełc, *Czy OFE powinny mieć możliwość inwestycji w instrumenty pochodne?* [Should Open Pension Funds Be Able to Invest in Derivatives?], BANKIER.PL, Aug. 17, 2004, available at http://www.bankier.pl/wiadomosci/print.html?article_id=1191058.

¹¹⁴ See Węglewski, *supra* note 107; *100 sekund skandalu na GPW—cd.* [100 Seconds of Scandal on the WSE—Continued], GAZETA WYBORCZA, Mar. 19, 2004 [hereinafter *100 Seconds of Scandal*], available at <http://serwisy.gazeta.pl/metroon/1,0,1977788.html>.

If investors do not have equal market opportunity and at any moment may get “worked over” for big money, as if they were facing a street hoodlum, no investor will want to “play” in such a market—they will either take their game somewhere else or stop investing. The Polish exchange could, in short order, become a worthless market, where only a handful of investors along with some pension and investment funds will come to play. Neither the WSE nor the KPWiG [Polish Securities and Exchange Commission (the Polish SEC)] likely wants such a situation.¹¹⁵

On one hand, the scandal appeared to be classic manipulation that could occur in any market with inefficiencies. The manipulator establishes a price trend and then profits by trading against it.¹¹⁶ On the other hand, the debacle had everything to do with the special nature of futures and their associated stop-loss orders. “Stop-order gunning” is the term investors use to describe the tactic of triggering multiple stop orders at once in order to manipulate prices. The manipulator in this case timed the effects of his gunning perfectly.¹¹⁷ Various sources in the Polish press suggest that the incident was not an isolated instance of stop-order gunning—at least three other similar incidents occurred.¹¹⁸

¹¹⁵ See *100 Seconds of Scandal*, *supra* note 114.

¹¹⁶ Mahoney, *supra* note 99, at 148 (citing Robert Jarrow’s market-manipulation model).

¹¹⁷ See, e.g., Wendy Collins Perdue, *Manipulation of the Futures Markets: Redefining the Offense*, 56 *FORDHAM L. REV.* 345, 398–99 (1987); Jerry W. Markham, *Manipulation of Commodity Futures Prices: The Unprosecutable Crime*, 8 *YALE J. ON REG.* 281, at 295–96 n. 75 (1991).

¹¹⁸ See Dziadkowiak, *supra* note 107 (noting that “something similar has already occurred twice but was taken for error of the broker placing the order”); Paweł Rejczak, *Podsumowanie wyników systemu inwestycyjnego dla rynku futures po I półroczu 2004 [A Summary of Investment Results for the Futures Market after the First Half of 2004]*, *EUROBANKIER.PL*, Aug. 5, 2004, available at http://euro.bankier.pl/edu/multiarticle.html?article_id=1187009&position=1 (noting that in addition to the Feb. 4 incident, a similar action had occurred on Jan. 8); Paweł Rejczak, *Futures: Nerwowe wahanie na niższym poziomie [Futures: Nervous Variance at a Lower Level]*, *BANKIER.PL*, Mar. 19, 2004, available at http://www.bankier.pl/wiadomosci/print.html?article_id=1069043 (noting that a slew of simultaneous stop orders could have been the result of manipulation).

2. Official reactions to the scandal and legislative development under Polish law

Two minutes after the 100-second incident came to a close, the Polish SEC had already begun to scrutinize all of the involved transactions—who had gained and who had lost.¹¹⁹ In a press conference, Jacek Socha, chairman of the Polish SEC, clarified that their initial efforts concentrated on discovering whether the incident had occurred pursuant to broker error or actual fraud.¹²⁰ One week later, Socha declared: “There can be no doubt that the events of last Wednesday were of a criminal character.”¹²¹

On the Thursday following the incident, the Polish SEC had informed both the General Inspector of Financial Information and the Internal Security Agency of wrongdoing. The general inspector froze the order-placing investor’s Polish bank accounts.¹²² Polish SEC investigation further revealed that the person who actually placed the orders was not an authorized broker.¹²³ The broker, from the Polish brokerage house PKO BP, had given his access code to an office friend—in contravention of Polish securities regulation—who then placed the orders. The Polish SEC suspended the broker for six months, and PKO BP moved quickly to dismiss both the broker and his colleague.¹²⁴

By March 19, at least ninety investors had turned to the Individual Investors Association for help in seeking restitution.¹²⁵ PKO BP offered to allow all injured investors to set up brokerage accounts on preferential terms, a move that the Association deemed an insult.¹²⁶ The Association and its investors preferred initiating a civil action against PKO BP, but bemoaned lack of clarity in the

¹¹⁹ Andrzej Stec, *100-sekundowy szwindel na giełdzie* [100-Second Swindle on the Exchange], *GAZETA WYBORCZA*, Feb. 10, 2004 [hereinafter *100-Second Swindle on the Exchange*], available at <http://serwisy.gazeta.pl/metroon/1,0,1907909.html?ustawEnergis=1>.

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.* The Individual Investors Association is a Polish nonprofit group based in Wrocław, Poland, the mission of which is to educate individual investors and lobby for investment-related best practices. See *O Stowarzyszeniu* [About the Association], http://www.sii.org.pl/stow_ostow.php (last visited Mar. 21, 2006).

¹²⁶ *Id.*

Polish statutory scheme and lack of desire on the part of prosecutors to bring criminal charges:

Documenting a definition of manipulation is fundamentally important. In the [Warsaw] prosecutor's office, the head of the division for crimes in the capital markets represented the train of thought shared by judges and, lamentably, prosecutors. The thrust seems to be that if there is no concrete provision spelling out what constitutes manipulation, then manipulation never occurred. This rigid, legalistic approach has, according to judicial statistics, prevented any change in this area for years.¹²⁷

The opaque statute to which the Association referred was Poland's 1997 Law on the Public Trade of Securities.¹²⁸ Following passage of the 1997 law—and as Poland began to prepare for E.U. accession—Polish legislators worked to amend the statute so that it would reflect E.U. standards. As amended on December 8, 2000, the statute included “crimes in opposition to the public exchange of securities” and provided public prosecutors with the power, in accordance with existing law, to bring charges where such crimes occurred.¹²⁹ Although Polish lawmakers clearly included exchange-traded derivatives, nowhere did their amendment describe the various forms that criminal securities violations might take.¹³⁰ Instead, the statute simply acknowledged the existence of such crimes and empowered prosecutors to act as they saw fit.

¹²⁷ Stowarzyszenie Inwestorów Indywidualnych [Individual Investors Ass'n], *4 lutego na rynku futures—ciąg dalszy nastąpi* [4 Feb. on the Futures Exchange—To Be Continued], ONET.PL (Mar. 25, 2004), available at <http://gielda.onet.pl/0,1156246,komentarze.html>.

¹²⁸ Ustawa z dnia 21 sierpnia 1997 r. Prawo o publicznym obrocie papierami wartościowymi [Law of 27 Sept. 1997, Statute on the Public Trade of Securities] (Dz.U. z 1997 r. Nr 118 poz. 754) [hereinafter Polish Securities Law].

¹²⁹ Ustawa z dnia 8 grudnia 2000 r. o zmianie ustawy—Prawo o publicznym obrocie papierami wartościowymi—w związku z dostosowaniem do Prawa Unii Europejskiej [Law of 8 Dec. 2000 Amending the Law—Statute on the Public Trade of Securities—in Connection with Conforming to the Law of the European Union] art. 4(10) (Dz.U. z 2000 r. Nr 122 poz. 1315), at 18 [hereinafter 2000 Amendments].

¹³⁰ See Polish Securities Law, *supra* note 128, art. 3(3). The 1997 statute provided that “securities” included “property rights whose price either directly or indirectly depends on the price of [stocks and bonds] (derivative rights).” *Id.*

Although fully able to act under the securities law amendments of 2000, Warsaw prosecutors initially did nothing to prosecute the February 4 manipulation.¹³¹ In contrast to this law enforcement inertia, the Polish Sejm (parliament) approved and published further amendments to the 1997 securities law on March 12, 2004.¹³² In introducing the amendments, Polish legislators noted: “This law accomplishes, in the scope of its regulation, incorporation of...[E.U.] directive 2003/6...[in the matter of] market manipulation.”¹³³ Article 97 of the updated statute explicitly addressed market manipulation, adopting almost word-for-word the broad-brush definition of manipulation suggested by the E.U. in its Directive:

(1) Manipulation of financial instruments, hereafter “manipulation,” is prohibited. (2) Manipulation shall be...placing orders, entering into transactions or undertaking other actions which give, or are likely to give, false signals as to the demand for, supply of, or price of financial instruments unless the reasons for entering into such actions were legitimate, and such orders, transactions, or other actions did not violate accepted market practices on the regulated market concerned.¹³⁴

As in the E.U. directive, Polish legislators chose not to prescriptively define manipulation, opting instead to outline general conduct in a way that gives law enforcement agencies latitude in pursuing criminal action.

Further, Polish legislators stiffened the proposed penalty for perpetrating market manipulation. In addition to the administrative sanctions that the E.U. suggested in Directive 2003/6, which gives the Polish SEC power to impose fines, the Polish government reserved the right to fine offenders up to PLN 5 million or impose a prison sentence of up to five years or both.¹³⁵ All of the March 12

¹³¹ Stowarzyszenie Inwestorów Indywidualnych, *supra* note 127.

¹³² Ustawa z dnia 12 marca 2004 r. o zmianie ustawy—Prawo o publicznym obrocie papierami wartościowymi oraz o zmianie innych ustaw [Law of 12 Mar. 2004 Amending the Statute on the Public Trade of Securities and Other Statutes] (Dz.U. z 2004 r. Nr 64 poz. 594).

¹³³ *Id.* at 1, n. 1.

¹³⁴ *Id.* art. 97, at 75.

¹³⁵ *Id.* art. 177, at 117.

amendments to the Polish securities statute took effect on May 1, 2004, the day that Poland entered the E.U.¹³⁶

By April 2004, indications began to appear that the malefactors of February 4 might meet justice after all. Although the Internal Security Agency (ISA) had yet to pin down the identity of the investor behind the “100 second” manipulation, the Warsaw prosecutor used ISA agents to apprehend the PKO BP broker and his order-placing accomplice on April 5.¹³⁷ The prosecutor subjected both individuals to constant supervision and prohibited them from leaving the country.¹³⁸ In September, a report arose suggesting that the Warsaw prosecutor would press charges against both parties.¹³⁹

However, charges never arose. One year after the scandal took place, on February 4, 2005, Andrzej Stec wrote for the *Gazeta Wyborcza*, Poland’s largest newspaper:

It initially seemed that justice would be satisfied. The [Polish SEC] gauged the accounts of the secret investor and its agent in rapid tempo.... [Now] however, injured investors possess less and less hope that the guilty will meet punishment. As of today, no charges have arisen, the accounts of the investor were unblocked, and the money disappeared—probably to Switzerland.¹⁴⁰

The Warsaw prosecutor’s reply to such concerns was twofold. Fundamentally, the reply claimed securities cases simply require a long time to prepare and execute. Moreover, it underscored the fact that its division for prosecuting securities crimes had only six attorneys, each of whom had an average of ten active Polish SEC–

¹³⁶ *Id.* at 118.

¹³⁷ Andrzej Stec, *100 sekund skandalu—dwóch zatrzymanych* [100 Second Scandal—Two Apprehended], *GAZETA WYBORCZA*, Apr. 6, 2004, available at <http://serwis.gazeta.pl/metroon/1,0,2009248.html>.

¹³⁸ *Id.*

¹³⁹ Michał Śliwiński, *Afera z 4 lutego—sprawcy nieznan* [The February 4 Scandal—Perpetrators Unknown], *INTERIA.PL*, Sept. 23, 2004, available at <http://mojeinwestycje.interia.pl/news?inf=545602>.

¹⁴⁰ Andrzej Stec, *100 sekund rok później* [100 Seconds a Year Later], *GAZETA WYBORCZA*, Feb. 4, 2005 [hereinafter *100 Seconds a Year Later*], available at <http://serwis.gazeta.pl/metroon/1,0,2528174.html>.

referred cases.¹⁴¹ The prosecutor claimed charges could be filed as soon as May 2005, however, charges have yet to arise.¹⁴²

It remains unclear why the WSE did not simply suspend trading when prices began to drop on February 4, 2004. Section 142 of the exchange's regulations provides that the WSE will suspend trading whenever the price of a traded security varies, at most, more than \pm ten percent from the normal trading price.¹⁴³ Traders refer to such provisions for automatic suspension as "circuit breakers."¹⁴⁴ One analyst noted that the execution of the "100 second" trade took place in such a manner that neither the initial dip nor the resulting spike in trading prices tripped the WSE circuit breakers (although both came quite close).¹⁴⁵ As a result, the WSE modified the futures-trading variance that it would tolerate before suspending trade to five percent instead of ten percent.¹⁴⁶

3. Assessment and suggestions

The solution to manipulation of the Polish futures exchange and other comparably sized exchanges is clear-cut: increase liquidity and market capitalization. As trade volume and market transparency increase, other investors price out would-be manipulators and thus destroy their ability to manipulate the market. The solution, however, poses a paradox. For manipulation to cease, Poland must have a thicker market; but market manipulation undermines the necessary investor confidence needed to induce large scale spending.

Technical fixes, such as the WSE circuit breaker modification, seem unlikely to resolve the problem. Many commentators have observed that circuit breakers often work to impede normal trading.¹⁴⁷ Economist Merton Miller remarked that, by their design, circuit breakers "shut down the markets and stop business from

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ Regulamin Giędy Papierów Wartościowych w Warszawie S.A. [Reg. of the Warsaw Stock Exchange] § 142(1)–(5) (Feb. 24, 2004).

¹⁴⁴ See, e.g., *Inter-exchange Procedures in Volatile Markets for Second Quarter 2005*, REG. CIRCULAR (Chicago Bd. Options Exch., Chicago, Ill.), Apr. 22, 2005, at 1; Jerry W. Markham, *Federal Regulation of Margin in the Commodity Futures Industry—History and Theory*, 64 TEMP. L. REV. 59, at 139 n.549 (Spring 1991).

¹⁴⁵ See Dziadkowiak, *supra* note 107.

¹⁴⁶ *Id.*

¹⁴⁷ See, e.g., Markham, *supra* note 144; Greg Burns, Commentary, *Circuit Breakers Do More Harm Than Good*, BUS. WK., Aug. 5, 1996, at 72.

being done.”¹⁴⁸ Miller’s comment seems all the more pertinent for markets like Poland where trading is naturally more volatile and thus more likely to trip circuit breakers and suspend trading. Proponents of circuit breakers argue that allowing investors to digest needed information and make rational decisions when trading varies significantly from normal volumes mitigates the inconvenience caused by such technical fixes. However, instances such as the “100 second” scandal prove otherwise. Providing only a false sense of security, circuit breakers and other technical remedies simply add an extra element of contest for manipulators who wish to abuse the market.¹⁴⁹

Merely providing a definition of manipulation that covers most or all of the conduct that regulators deem unlawful will not solve the paradox. Jerry Markham, former chief counsel for the U.S. Commodity Futures Trading Commission (CFTC), remarked: “[I]t may be appropriate to maintain a residual broad prohibition against manipulation that will sweep up unusual or novel manipulation techniques....[However,] a completely different regulatory approach is needed to attack the concerns raised by manipulation.”¹⁵⁰

The “completely different approach” that Markham advocated—in the context of discussing apparent CFTC failure to stifle manipulation in U.S. commodity futures trading—centered on creation of a “fair and orderly market” as opposed to a *laissez-faire* system of trading.¹⁵¹

The concept of a fair and orderly market would lead to an overall approach of prevention, intervention and prosecution....The purpose of maintaining an orderly market is to assure that prices reflect actual conditions and are not the result of disruptive trading by powerful market forces that have the wherewithal to unduly affect prices. The requirement of a fair and orderly market reflects a

¹⁴⁸ Burns, *supra* note 147.

¹⁴⁹ See, e.g., Christopher J. Mailander, *Financial Innovation, Domestic Regulation and the International Marketplace: Lessons on Meeting Globalization’s Challenge Drawn from the International Bond Market*, 31 GEO. WASH. J. INT’L L. & ECON. 341, 385 n.297 (1997/1998) (citing an OECD study in which it was found that “circuit breakers...have not proved effective in reducing volatility due to the market’s ability to circumvent such restrictions”).

¹⁵⁰ Markham, *supra* note 117, at 361.

¹⁵¹ *Id.*

social judgment that large traders should not be permitted to abuse these markets by causing disruptions affecting consumers and the economy in general....All of these efforts must be coupled with an effective program of prosecution. This program must provide for both criminal and civil penalties.¹⁵²

Markham's "different approach" seems well suited to remedy the Polish paradox. Due to the relatively fragile state of this market, the Polish futures exchange officials must regulate in a way that will bolster investor confidence. Confidence will follow in the wake of regulation and enforcement that reflect investor sentiment that "large traders should not be permitted" to abuse and disrupt futures trading.

Concerned less with *laissez-faire* and more with boosting investor confidence, authorities of the Polish securities commission and the Warsaw exchange have already worked hard to implement two of the three "Markham Approach" criteria—prevention and intervention. Evidence suggests that the Polish SEC and WSE have tried to prevent market manipulation. One such prophylactic, though largely ineffective method, is the imposition of circuit breakers that the WSE has put in place. Further, the Polish SEC has observers who actively monitor the price and volume of trades on the futures exchange, as evidenced by the commission employees who examined the "100 second" trades only moments after they took place.¹⁵³ Although one could argue that it acted too slowly, the Polish SEC did intervene by freezing the investor's accounts, suspending the involved brokers, and informing the prosecutor's office. In an attempt at effective intervention, each year the Polish SEC refers dozens of cases to the Prosecutor's office.¹⁵⁴ Unfortunately, referral is often where the trail ends.

In the decade from 1994 to 2004, the Warsaw prosecutor's office pressed charges in only twenty-three percent of the cases referred by the Polish SEC—an annual average of nine prosecutions for every thirty-seven referrals.¹⁵⁵ Presumably, the ratio of convictions to referred cases is much lower. Herein lies the

¹⁵² *Id.* at 363–64, 374.

¹⁵³ *100-Second Swindle on the Exchange*, *supra* note 119.

¹⁵⁴ *100 Seconds a Year Later*, *supra* note 140.

¹⁵⁵ *Id.* Averages are derived on calculations of the author based on given figures.

failure of Poland's futures exchange to reflect the ideal of a "fair and orderly market." The securities commission and the exchange are limited in their efforts to prevent and intervene when no manipulator faces the prospect of effective and conclusive prosecution. Markham stresses that effective regulation of manipulation in the futures context must include criminal prosecution that is concentrated (i.e., "sufficiently pointed in attacking particular practices"), quick, and efficient.¹⁵⁶

The March 12 amendments to Poland's securities law allow for "concentrated" criminal prosecution because they specify practices that prosecutors can identify and pursue. Lawmakers can give a working definition of manipulation that facilitates concentrated prosecution; however, quick and efficient prosecution cannot be legislated. Complicating quick and efficient prosecution of the "100 second" offenders is the fact that prosecutors cannot retroactively apply a March 2004 statute to conduct that occurred in February 2004. This objection to retroactive application, however, poses no real practical concern since prosecutors were and remain free to use the securities law as it existed in 2000 to prosecute "crimes in opposition to the public exchange of securities."¹⁵⁷ Working with such broad statutory language, prosecutors have latitude to single out the criminals of February 4 and impose criminal sanctions.

Beyond the "100 second incident," the Warsaw prosecutor's office must take an affirmative role in assisting the Polish SEC and the WSE in their efforts to regulate the Polish futures market. One step that the prosecutor's office might take would be to increase the number of personnel employed to work on securities related crimes. Understaffing in the securities arena, however, seems more of a pretext than an actual impediment. Six prosecutors might not be able to successfully prosecute thirty-seven cases annually, but one presumes that nine cases a year—one-and-a-half actions per prosecutor—is low.¹⁵⁸

The dismal ratio of prosecutions to filed charges strongly suggests that lack of training and motivation lie at the heart of the problem. Raising the number of prosecutors might help, but Warsaw prosecutors must likewise seek E.U. funding and guidance in an effort to train prosecutors to take more effective legal action against instances of manipulation. Newly enacted E.U. provisions

¹⁵⁶ Markham, *supra* note 117, at 374.

¹⁵⁷ 2000 Amendments, *supra* note 129.

¹⁵⁸ *100 Seconds a Year Later*, *supra* note 140.

can and should be a call to action for law enforcers in Poland and other new member states. Where clearly defined national norms did not exist previously, E.U. guidance has filled the void. Although European regulators seek implementation of post-FSAP measures, the reaction of Polish prosecutors to the February 4 scandal after implementation of Directive 2003/6 shows that local regulators have yet to fully assume the challenge. As a result, one cannot yet gauge whether administrative and criminal sanctions at the local level will achieve “effective, proportionate and dissuasive” outcomes.¹⁵⁹

C. Legal Risk in the Polish OTC Derivatives Market: The Credit Support Annex and Close-out Netting

Poland is largely a jurisdiction where the law permits close-out netting.¹⁶⁰ In an opinion commissioned by ISDA members, the Warsaw office of Allen & Overy comments generally that close-out netting “would be enforceable under Polish law in the event of voluntary or involuntary winding up proceedings in respect of a Polish entity.”¹⁶¹ However, this generally favorable situation can be complicated when the parties enter into a Credit Support Annex (CSA) under the ISDA Master Agreement.

The CSA under an ISDA Master Agreement serves essentially the same function as a mandated margin account in the exchange-traded context. The CSA allows one or both parties to pledge collateral based on the value at risk in a given transaction.¹⁶² As part of the ISDA Master Agreement’s “single agreement” framework, the CSA is intended to be netted with and rolled into the calculation of all other close-out payments when one party defaults or becomes insolvent.¹⁶³ The Polish Bankruptcy Law of 2003 prevents this from happening when the ISDA Master

¹⁵⁹ Parliament and Council Directive 2003/6/EC, *supra* note 51.

¹⁶⁰ Memorandum of Law from Allen & Overy (Warsaw) for the International Swaps and Derivatives Association on Enforceability Under Polish Law of Close-out Netting of Privately Negotiated Derivatives Transactions Under the 1992 ISDA Master Agreement and the 2002 ISDA Master Agreement (Feb. 9, 2004) [hereinafter Polish Netting Memorandum] (on file with author).

¹⁶¹ *Id.* at 6.

¹⁶² INT’L SWAPS & DERIVATIVES ASS’N, USER’S GUIDE TO THE ISDA CREDIT SUPPORT DOCUMENTS UNDER ENGLISH LAW 2 (1995). The workings of the CSA under New York law are essentially similar.

¹⁶³ *Id.* at 5; 2002 MASTER AGREEMENT, *supra* note 36, at 11.

Agreement is subject to Polish law, making the CSA amount a sum that could potentially be cherry picked by a Polish bankruptcy administrator.¹⁶⁴

The Polish Netting Opinion explains that “[t]ermination provisions of the Master Agreement [including close-out netting] may not apply to any transactions that do not qualify as ‘term financial transactions’ under Article 85.3 of the [Polish] Bankruptcy Law.”¹⁶⁵ In turn, Article 85.2 of the Polish Bankruptcy Law defines term financial transactions as transactions “with a specified price, quotation, interest rate or index, and in particular the acquisition of funds, securities...entered into for settlement on a specified date or for a specified period of time, on the market place.”¹⁶⁶ The CSA falls outside of the sphere of transactions qualifying for close-out netting under Polish law.

This legislative bind could matter in the following situation. Suppose that two parties, a Polish bank and a Polish oil company, have many open derivatives trades under an ISDA Master Agreement governed by Polish law. They enter into a large interest rate swap to hedge the oil company’s exposure to one of its creditors. Given the size and significance of the swap, the parties decide to enter into a CSA in relation to the swap so that each will be able to pledge funds to cover any open position. As time progresses, the swap moves in the oil company’s favor and the bank sets aside money in an escrow fund established under the CSA. The oil company then declares bankruptcy and soon after tries to apply close-out netting. The calculation netting all open trades outstanding between the bank and the oil company—including the CSA amount—produces a net sum owed to the bank. However, since investors cannot add the CSA to the netting equation under the Polish Bankruptcy Law, the amount remains outstanding in the oil company’s favor and the Polish bankruptcy administrator is free to claim the amount for the bankrupt estate.

One solution to this problem might simply be for the parties to make their agreement subject to a jurisdiction where this problem does not arise. However, due to raised transaction and potential dispute costs, many parties may wish to continue trading under Polish law. In order to make the regime for close-out netting more

¹⁶⁴ Polish Netting Memorandum, *supra* note 160, at 5, 7; Polish Bankruptcy Law, *supra* note 100, at 132.

¹⁶⁵ Polish Netting Memorandum, *supra* note 160, at 7.

¹⁶⁶ *Id.* at 5, 7; Polish Bankruptcy Law, *supra* note 100, at 132.

equitable for both parties, Polish legislators must update the Bankruptcy Statute to allow agreements such as the CSA to fall within the purview of transactions in which netting is permissible in bankruptcy. Doing so would move the Polish market closer to the ideal of the E.U. as expressed in its Insolvency Regulation, where legislators sought to preserve the rights of creditors to set-off their claims against the claims of parties in bankruptcy.¹⁶⁷

D. Derivatives Accounting Standards and the Polish OTC Market

1. The quest to smooth earnings

Recent U.S. headlines AIG and Fannie Mae demonstrate a familiar story about financial managers who seek to smooth earnings and hide financial risk.¹⁶⁸ Other recent literature in both law and finance sets forth the contours as follows.¹⁶⁹ In the late 1980s, executive salaries in publicly traded companies increasingly began to depend on equity compensation.¹⁷⁰ Managers whose salary was part equity had special incentive to please the market and increase share price. A crucial aspect of pleasing the market centered on meeting the projections of analysts who tell the market what to expect from given companies. The price for failing to meet

¹⁶⁷ See Council Regulation 1346/2000, *supra* note 51.

¹⁶⁸ See, e.g., Kurt Eichenwald & Jenny Anderson, *How a Titan of Insurance Ran Afoul of the Government*, N.Y. TIMES, Apr. 4, 2005, available at <http://www.nytimes.com/2005/04/04/business/04aig.html> (noting that the SEC began its investigation upon seeing an A.I.G. brochure advertising how a “product deemed ‘loss mitigation insurance’ could be used by public companies to present smooth earnings performance to investors, even amid losses”); *School for Scandal: Dangers of the US Mortgage Giant’s Special Status*, FIN. TIMES, Dec. 22, 2004, at 16 (noting that “the result of Fannie’s hedge accounting exercise was to smooth earnings by neutralising the impact of marking derivatives to market”).

¹⁶⁹ See, e.g., John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269 (2004); Adriaen M. Morse, Jr., *Breaking the Circle: The Problem of Independent Directors Policing Public Company Financial Disclosure Under the SEC’s New Rules Governing Public Company Audit Committees*, 23 ANN. REV. BANKING & FIN. L. 673, at 674 (2004); Arthur Levitt, Chairman, S.E.C., Remarks at the NYU Center for Law and Business, *The “Numbers Game,”* (Sept. 28, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>.

¹⁷⁰ See Coffee, *supra* note 169, at 274–75; see also Tom Nohel & Steven Todd, *Compensation for Managers with Career Concerns: The Role of Stock Options in Optimal Contracts*, 11 J. CORP. FIN. 229 (2005).

analyst expectations—even slightly—is investor stock-dumping.¹⁷¹ Thus, managers strove to either hit analyst forecasts or exceed them to the extent possible. Commenting on the tendency for investment banks to override common business sense, former SEC chairman Arthur Levitt said: “Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation.”¹⁷²

Corporate managers have repeatedly played this game in their treatment of derivative financial instruments. To smooth earnings, financial managers can and do try to manipulate accounting rules in deciding when and how to recognize a gain or loss on a derivative contract.¹⁷³ This problem is not unique to American shores as the *Financial Times* reports similar problems in Europe:

Managements—at French banks, for instance—are reluctant to give up techniques [in the treatment of derivatives] that help them “smooth” earnings from one year to another. Their assumption is that users of accounts prefer smoothed outcomes.... As for smoothing the accounts, that was one of the motives that led Fannie Mae, the U.S. mortgage finance provider, allegedly to flout FAS 133, the U.S. equivalent of IAS 39. According to Fannie’s regulator, smoothing became manipulation of earnings—to which executive bonuses were related.¹⁷⁴

The implicit lesson for regulators is that wherever fluid capital markets, analyst projections, equity driven management, and

¹⁷¹ See Coffee, *supra* note 169, at 277.

¹⁷² Levitt, *supra* note 169.

¹⁷³ See *School for Scandal*, *supra* note 168 (noting that Fannie Mae inappropriately applied hedge accounting to some of its derivatives contracts in contravention of FAS 133); Elizabeth MacDonald, *Kicking Fannie*, FORBES, Mar. 14, 2005, at 110 (noting that Fannie Mae “incorrectly...smoothed out earnings by temporarily ignoring the day-to-day fluctuations in the value of the derivative contracts it uses to hedge interest rate risks”); see also Monica S. Tew, Notes & Comments, *The Dark Side of Derivatives: A Book Note on Infectious Greed: How Deceit and Risk Corrupted the Financial Markets* by Frank Partnoy, 8 N.C. BANKING INST. 289 (2004) (commenting on improper accounting for derivatives by Enron).

¹⁷⁴ Fuller, *supra* note 92.

derivatives converge—a convergence that seems to be materializing in Poland—management might feel pressured to manipulate earnings and OTC derivatives could be one tool utilized in the effort to do so.

This pressure to manipulate earnings is precisely why IAS 39 requires firms to place derivatives on the balance sheet at fair value as an asset or a liability. When regulations require companies to make full disclosure they have less ability to hide risk (assuming no foul play). However, the European Commission's IAS 39 carve-out compromises this objective. Where American firms must overtly flout accounting standards to achieve artificially smoothed outcomes, firms in the E.U. need only exploit a prepackaged carve-out, giving reason to wonder whether abuse of the provision could occur in the Polish market.

2. The Polish market and the possibility of carve-out exploitation

OTC derivatives-related developments in Poland merit special attention for a number of reasons. As discussed in the introduction, Polish OTC derivatives trading has consistently risen since 1995.¹⁷⁵ In 2004, Poland's average daily turnover in reported OTC derivatives stood at US\$6 billion, more than the Czech Republic and Hungary combined. Citing just one example, PKN Orlen—Poland's largest petrochemical company and the largest company listed on the WSE—boosted the fair-value amount of its derivatives by 387% from PLN 23 million to PLN 89 million in the one year period from 2002 to 2003.¹⁷⁶

A large portion of Poland's everyday OTC trading volume passes through Poland's biggest banks. The Bank for International

¹⁷⁵ *BIS Derivatives Survey 2004*, *supra* note 11, at 19; *BIS Derivatives Survey 1998*, *supra* note 11, at 19.

¹⁷⁶ PKN ORLEN, 2003 RAPORT ROCZNY [ANNUAL REPORT] 138 (2004). Orlen, like all public companies in Poland, prepares its financial statements according to the IASB International Financial Reporting Standards (IFRS). Under IFRS, fair value is "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." INT'L FIN. REPORTING STANDARDS, *supra* note 83, at 39-15. In other words, the growth in PKN's derivatives use does not merely represent a growth in the notional amount of the derivatives that it uses, but a growth in the so-called "value at risk." This fair-value, value-at-risk amount represents PKN's actual exposure. In U.S. dollars, the cited figures represent growth from about \$7 million to about \$25 million.

Settlements (BIS) provides the following breakdowns for OTC trading in Poland:¹⁷⁷

OTC FOREIGN EXCHANGE DERIVATIVES TURNOVER BY COUNTERPARTY IN APRIL 2004	
NET TURNOVER	POLAND DAILY AVERAGES (IN MILLIONS USD)
With Reporting Local Dealers	337
With Reporting Dealers Abroad	2783
With Other Financial Institutions	1095
With Nonfinancial Customers	389
Total	4604
Gross Turnover	4941

OTC FOREIGN EXCHANGE DERIVATIVES TURNOVER
BY COUNTERPARTY IN APRIL 2004

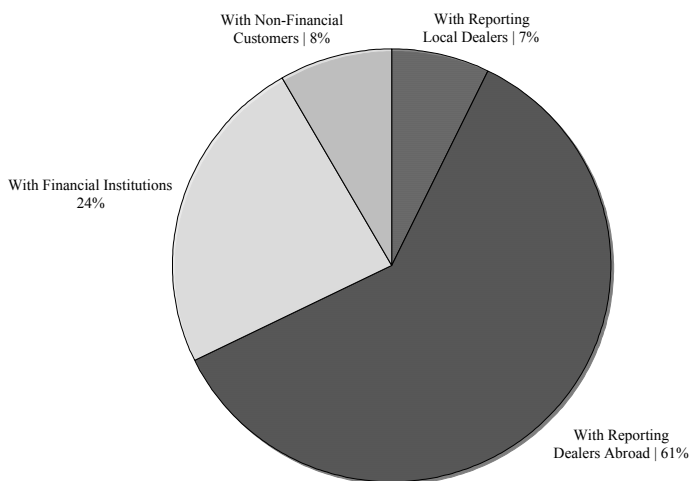


Fig. 2 (created by the author on the basis of BIS figures)

¹⁷⁷ *BIS Derivatives Survey 2004, supra* note 11.

OTC SINGLE CURRENCY INTEREST RATE DERIVATIVES TURNOVER BY COUNTERPARTY IN APRIL 2004	
NET TURNOVER	POLAND DAILY AVERAGES (IN MILLIONS USD)
With Reporting Local Dealers	270
With Reporting Dealers Abroad	501
With Other Financial Institutions	172
With Nonfinancial Customers	15
Total	958
Gross Turnover	1228

OTC SINGLE CURRENCY INTEREST RATE DERIVATIVES TURNOVER
BY COUNTERPARTY IN APRIL 2004

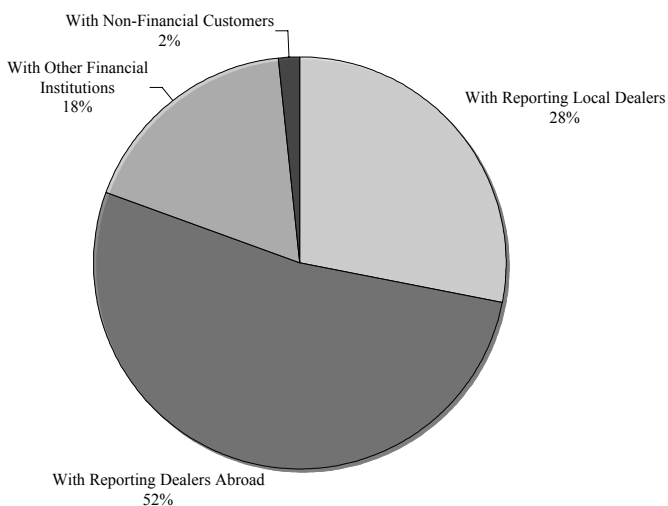


Fig. 3 (created by the author on the basis of BIS figures)

BIS defines “reporting local dealers” and “other financial institutions” to include commercial and investment banks, insurance companies, brokerage houses, and so forth. In sum, Polish reporting local dealers and other financial institutions share approximately US\$1.8 billion of daily OTC derivative turnover. Public trading of many, if not most, of these institutions occurs on the WSE, and all of these institutions are subject to IAS 39.

On August 27, 2004, the Sejm amended its 1994 statute on accounting standards.¹⁷⁸ Prior to the amendments, Polish banks and publicly traded companies had prepared financial statements according to Polish accounting standards. The 2004 amendments recognized that beginning January 1, 2005, publicly traded Polish companies and all Polish banks would prepare financial statements in accordance with international financial reporting standards and E.U. interpretations of those standards.¹⁷⁹ Of course, part of the E.U. interpretation of IFRS includes Regulation 707/2004, which introduced the carve-out to IAS 39. As a result, Polish institutions—banks in particular—that use derivatives are free under Polish and E.U. law to exclude those derivatives from the balance sheet or to mark them at unfair values as long as such derivatives fit the categories specified in the carve-out.

Another reason to look closely at the Polish market is that Polish companies are increasingly coming under the scrutiny of foreign investors and analysts. In March 2005, *International Securities Finance* reported:

Morley has launched a Central European long/short fund to be wholly managed and invested in Poland....Commenting on the launch of the fund, Ian Ainscow, head of international business development at Morley Fund Management, said: “The EU accession earlier this year has resulted in increased investor interest in Central European economies....We have seen increased demand for

¹⁷⁸ Ustawa z dnia 29 września 1994 r. o rachunkowości [Statute of 29 Sept. 1994 on Accounting], arts. 2(3), 45, 55 (Dz.U. z 2002 r. Nr 76 poz. 694), at 2, 46–47, 54; Ustawa z dnia 27 sierpnia 2004 r. o zmianie ustawy o rachunkowości oraz o zmianie ustawy o biegłych rewidentach i ich samorządzie [Statute of 27 Aug. 2004 Amending the Statute on Accounting and Amending the Statute on Auditors and Their Self-Regulation], art. 1 (Dz.U. z 2004 r. Nr 213 poz. 2155), at 1 [hereinafter Accounting Law Amendment].

¹⁷⁹ See Accounting Law Amendment, *supra* note 178, art. 1, at 1–2.

alternative investment products and the launch of this fund offers new diversification possibilities to a range of sophisticated investors.¹⁸⁰

Another such development was the announcement in February 2005 that the WSE approved Dresdner Kleinwort Wasserstein (DrKW) as its first investment bank foreign member.¹⁸¹ As of April 1, 2005, DrKW—one of Europe's leading investment banks—has made available a slate of institutional investors who will provide Polish businesses well heeled purchasers for their public offerings. Matthias Rode, head of equity flow derivatives for DrKW in Frankfurt, commented:

Since Poland's accession to the EU, our institutional clients in Western Europe—including mutual and hedge funds—have shown a great interest in the Polish market and so we see significant growth potential for our new product. The Polish equity market is attractive to our clients because it has depth and maturity with a number of liquid stocks, good daily turnover and a well developed derivatives market.¹⁸²

As the eyes of foreign and local investors begin to focus on publicly traded Polish companies, those companies will increasingly feel the same pressure as their Western European and American counterparts to produce smooth outcomes. Strategic derivatives accounting, including the familiar game of winks and nods, might conceivably emerge in a market where managers face mounting pressure to meet analyst predictions, contemplate the prospect of personal gain (or the spectacle of personal loss), and evaluate the available means for achieving desired outcomes at low cost. To the extent that Polish publicly traded companies can exploit the carve-out in IAS 39, the Polish market might see debacles comparable to AIG and Fannie Mae.

Gauging the scope of this risk is difficult. To do so would require examining both public and nonpublic financial data on

¹⁸⁰ *Polish Market Proves a Draw*, *supra* note 19.

¹⁸¹ Press Release, Dresdner Kleinwort Wasserstein, *supra* note 19; *see also Polish Market Proves a Draw*, *supra* note 19.

¹⁸² Press Release, Dresdner Kleinwort Wasserstein, *supra* note 19.

banks, publicly traded companies, and the projections of various investment banks and other analysts. Ideally, a significant correlation would exist between analyst projections, a company's earnings, and the timing and manner with which a company or bank closes out its derivatives contracts. An undertaking of this scale is beyond the scope of the present paper. Instead, this work briefly examines one prominent Polish bank that is a WSE blue chip and assesses whether the bank's situation allows it to exploit IAS 39 as understood in the light of Regulation 707/2004.

3. Profile of a market participant: Pekao

Poland's largest commercial banks, which compose a large share of the WSE's total market capitalization, are regular users of derivatives.¹⁸³ Pekao is one such bank. Established in 1929 and currently the second largest bank traded on the WSE, Pekao is a strong performer.¹⁸⁴ In 2004, its return on equity was 18.4%, and it consistently outperformed the WIG 20 by a significant margin.¹⁸⁵ Pekao merits attention due to a number of factors, including its prominence as a Polish market leader, its use of an equity driven management, and its use of derivatives. As many U.S. firms have begun to abandon options as a form of compensation,¹⁸⁶ Pekao and other Polish firms have just begun instituting stock option plans.¹⁸⁷ In July 2003, Pekao approved "creation of a motivational program for managers of the Bank's capital group, who are key to realizing the Bank's strategy."¹⁸⁸ The Pekao program granted 14.1 million long term stock options to managers in a two step transaction.¹⁸⁹ Although option-based motivational schemes have some relevance

¹⁸³ See, e.g., PEKAO, 2004 RAPORT ROCZNY [ANNUAL REPORT] 109–10 (2005) (reporting PLN 551 million in total derivatives contracts); Kominek, *supra* note 14, at 1028–29 (reporting that many of the largest members of the WSE are commercial banks).

¹⁸⁴ Bank Pekao S.A., <http://www.gpw.com.pl/zrodla/gpw/zlote/pekao.html> (last visited Mar. 25, 2006).

¹⁸⁵ *Id.*; http://www.gpw.com.pl/images/spolkigieldowe/wykresy_zlot/year/B_PEKAO.png.

¹⁸⁶ Louis Lavelle, *Are Options Headed for Extinction?*, BUS. WK., May 2, 2005, at 12.

¹⁸⁷ See e.g., PKN ORLEN, *supra* note 176, at 146 (indicating that in 2003, Orlen for the first time granted its officers 254,493 stock options, all of which were exercised within the year); PEKAO, *supra* note 183, at 116–17.

¹⁸⁸ PEKAO, *supra* note 183, at 116–17.

¹⁸⁹ *Id.*

in assessing whether a firm poses a risk of accounting malfeasance, such schemes are not necessary or sufficient conditions for such malfeasance.

Whether or not a given firm has off-balance-sheet derivative positions is a more relevant factor in assessing such risk. In 2004, Pekao reported PLN 551 million of off-balance-sheet, OTC derivatives contracts, a sum equal to seven percent of its total assets of PLN 59 billion.¹⁹⁰ In its financial statement notes, Pekao relates that this sum is comprised of interest-rate swaps as well as currency forwards and swaps.¹⁹¹ As an institution that prepares its statements according to IFRS, IAS 39, and Regulation 707/2004, Pekao should use these instruments in “hedging relationships where...the hedged item is a net position; or where the hedge covers interest risk in a held-to-maturity investment,” thus allowing the off-balance-sheet treatment.¹⁹²

Pekao’s stated intention in using all of its derivatives contracts is to “manage the risks related to standard operations.”¹⁹³ Despite this legitimate purpose, derivatives contracts—measured at fair value—in an amount equal to seven percent of a company’s total assets are significant. The key question, therefore, is whether managers will be tempted to strategically close out derivatives contracts or mark them at other than fair value if it looks unlikely that the bank will hit the most recent earnings estimates. In a market with increasing scrutiny and competition where the means for earnings manipulation are available, regulators must pay close attention to the way that banks and other publicly traded entities account for their derivatives contracts.

V. CONCLUSION

On balance, the FSAP successfully provided a workable plan for introducing wide scale financial reform in the E.U. A key part of this reform overhauled the E.U.’s statutory structure for the regulation of derivatives in four key categories: risk management, clearance and settlement, accounting standards, and market manipulation. As the attention of European and member state regulators shifts from legislative drafting to local implementation

¹⁹⁰ *Id.* at 109–10.

¹⁹¹ *Id.* at 105–06, 109–10.

¹⁹² Commission Regulation 707/2004, *supra* note 51, Annex ¶ 29.

¹⁹³ PEKAO, *supra* note 183, at 105.

and enforcement, the derivatives provisions relating to accounting standards and market manipulation are particularly important for Poland and its neighboring states who recently joined the E.U.

Close-out netting poses a challenge for Polish legislators where parties utilize a Credit Support Annex under the ISDA Master Agreement. The regime allows bankruptcy administrators to inequitably claim amounts due under the Annex in situations where, in another jurisdiction, the amounts would belong to the non-bankrupt party according to the close-out netting calculation. Polish legislators must update their regime to reflect the E.U. regime, which preserves the right of creditors to set off all claims owing against a debtor.

The Polish securities commission and futures exchange regulators are attempting to prevent manipulation, and intervene when it occurs. However, the failure of Polish prosecutors to bring charges against manipulators has hindered efforts to establish a “fair and orderly” futures market. Polish regulators should train Polish prosecutors to prosecute the conduct specified in Directive 2003/6 and the most recent amendment to the Polish securities law more effectively.

Regarding accounting standards, the carve-out that the European Commission introduced into IAS 39 can potentially undermine the requirement that companies reflect all of their assets and liabilities at fair value. As a result, in Poland and other European member states where publicly traded entities have the ability and incentive to smooth earnings, regulators must pay close attention to the way such entities account for their derivatives contracts. Regulators will be able to circumvent the game of winks and nods by carefully implementing E.U. anti-manipulation standards and vigilantly watching the derivatives accounting habits of banks and other publicly traded companies.

