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Globalization of Financial Risks and International Supervision of Banks and Securities Firms: Lessons from the Barings Debacle

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I. Introduction

The testimony of various regulators at the 1995 Annual Meeting of the International Organization of Securities Commissions (IOSCO) in Paris, France, reflected a general consensus that international financial market regulation needs a new regulatory and supervisory model, if not regulatory and supervisory philosophy. For example, Mr. Andrew Large, Chairman of the United Kingdom's (UK's) Securities and Investment Board, recognized that both the securities markets and the nature of the participants in those markets have fundamentally and dramatically changed. Increasingly, sophisticated trading and risk management systems and the rise of derivative products that serve to unbundle and reallocate

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risks from instruments or transactions accelerate these changes.[1] Cross-border securities transactions are increasing with such velocity that regulators under the current supervisory framework have considerable difficulties determining which national regulator has jurisdiction over the varying transactions, the particular regulatory issues, or the new and differing risks.

Not only do the large securities firms conduct significant securities transactions that give rise to international regulatory issues, but so also do the large international banks.[2] However, banking and securities regulators have different approaches to regulating and supervising their respective entities; though they recognize the need to move toward a more common international regulatory and supervisory approach.[3]

The specific entities within the banking and securities industries (that is, banks, securities firms, mutual funds, pension funds, and hedge funds) also have internal institutional risks unique to their particular structures that must be isolated from the common framework.[4] Therefore, Mr. Large further opined that the envisaged common regulatory/supervisory model should focus on changes in systemic risk and should "present a coherent risk-based philosophy" to preserve the benefits of financial liberalization and deregulation.[5] In addition to identifying common principles and reference points, the risk-based philosophy should properly identify the risks that different firms pose to the international financial system and that the system poses to different firms, should consider the role that corporate structures play in reducing systemic risk, and should focus on the risk of endemic contagion within these structures.[6]

Regarding international banks, Mr. Tommaso Padoa-Schioppa, Chairman of the Basle Committee on Banking Supervision (Basle Committee), asserted that the Basle Committee has been the vehicle for regulatory cooperation and the force behind global supervision for global markets, international acceptance of consolidated supervision, and clear division of responsibilities between the home and host country supervisors for cross-border banking groups.[7] According to Mr. Padoa Schioppa, regulators must strive to follow the same supervisory treat-

1. *See* Andrew Large, President, Securities and Investment Board, *Globalization of Risks: Cooperation Between Banking and Market Regulators*, in Public Documents of the XXth Annual Conference of the International Organization of Securities Commissioners (IOSCO), Paris, 12 July 1995, TOME 1, No. 23, at para. 4.
2. Large, *supra* note 1, at para. 5.
3. *Id.* at paras. 9-10.
4. *Id.* at para. 14.
5. *Id.* at para. 17.
6. *Id.* at paras. 17-20.
7. *See* Tommaso Padoa-Schioppa, Chairman, Basle Committee on Banking Supervision, *Globalization of Risks: Cooperation Between Banking and Market Regulators*, in Public Documents of the XXth Annual Conference of the International Organization of Securities Commissioners (IOSCO), Paris, 12 July 1995, TOME 1, No. 24, at paras. 3-4. On the concept of consolidated supervision, Schioppa carefully noted that certain securities supervisors "still follow a different approach that concentrates supervision on the regulated broker-dealer, while certain affiliates are not subject to

ment for the same activities so that banking and securities regulators can realistically collaborate on an international level.[8] The prudential treatment of a given risk should be the same, whether incurred by banks, securities firms, or insurance companies, regardless of the location of the financial institution.[9] Schioppa characterized the recent supervisory initiatives regarding international banks as a movement towards "market-friendly supervision," meaning that banking supervision has increasingly aimed at promoting stability in the international financial system "by enhancing the disciplinary effects of markets rather than by limiting competition."[10]

Financial and technological innovations have rendered the segmentations and restrictions on the banking and securities markets, such as those engendered by the U.S. Glass-Steagall Act and Article 65 of the Japanese Securities and Exchange Law, ineffective to prevent instability and contagion. The proposed supervisory revolution envisages that regulatory defenses must be developed inside, as opposed to outside, the financial markets because advanced telecommunication technologies resulting in widespread information and capital flows and the increasing sophistication of investors, depositors, and creditors of these institutions instill discipline that is equal to or better than regulatory discipline.[11] This approach is founded on two defensive parameters: management control and market discipline.[12] Thus, supervisors should improve their knowledge base about new risks and innovative cross-border transactions and holdings and should introduce suitable measures to defend against systemic risk.[13]

Considerable optimism currently exists regarding the supervisory agendas of IOSCO and the Basle Committee. Increasingly, market participants are seizing the opportunity to draw upon the relative strengths of banking and securities regulatory cultures to achieve a better coordinated supervisory system.[14] The focus of banking regulation has traditionally been on the protection of depositors and payment systems, and regulators have normally relied on direct regulation and confidential supervision as opposed to market discipline. Securities regulation,

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supervision." *Id.* at para. 4. He was presumably referring to the U.S. Securities and Exchange Commission. On the Basle Committee generally, see, *inter alia*, JOSEPH J. NORTON, DEVISING INTERNATIONAL BANK SUPERVISORY STANDARDS (Kluwer 1995).

8. Schioppa, *supra* note 7, at para. 5.

9. *Id.* at para. 5.

10. *Id.* at para. 7.

11. Schioppa, *supra* note 7, at para. 7. For a discussion of the U.S. and Japanese situations, see J.J. Norton and C.D. Olive, *Regulation of Securities Activities of Banks: A Comparison of U.S. Regulation and Japanese Liberalization*, Ch. 5 to INVESTMENT BANKING: THEORY AND PRACTICE (E. Gardener *et al.*, eds., 1996).

12. *Id.* at para. 8.

13. *Id.* at para. 9.

14. *See* Remarks of Edward J. Waitzer, Chairman, IOSCO Technical Committee, Ontario Securities Commission, *Cooperation Between Banking and Market Regulators: Some Thoughts on the Role of IOSCO*, in Public Documents of the XXth Annual Conference of the International Organization of Securities Commissioners (IOSCO), Paris, 12 July 1995, TOME 1, No. 25, at 2.

however, is traditionally rooted in investor protection and the maintenance of fair and efficient markets. Within such broad parameters, the evolution of risk management is heavily influenced by market discipline. The revolution in banking, driven by the expanding activities of the large international banks, lead to the establishment of international financial groups that warrant the supervision of both the banking and securities regulators. As national regulators struggle with issues such as consolidated or coordinated functional regulation, lead regulators, and regulatory arbitrage, regulators must not impose inappropriate regulatory constraints on risk-taking activities and competition in a constantly changing international financial environment driven by the market participants themselves.

Acceleration of the process of market-driven regulatory convergence in financial services convinced regulators that markets have the capacity to absorb many disruptive events without coordinated regulatory intervention. As the Chairman of the IOSCO Technical Committee concluded, this observation underscores the premise underlying the supervisory revolution: "[d]ealing with low-probability events that pose potentially calamitous consequences."[15] This challenge should guide the member regulators of IOSCO and the Basle Committee to a more unified, transparent, global, regulatory framework, led by the more competent or sophisticated banking and securities regulators.

The globalization of finance further facilitates the need to eliminate inefficient national regulation. The competitive pressures of the international markets tend to influence domestic regulatory policy, which in turn underscores the importance of organizations like IOSCO and the Basle Committee.[16] The international supervisory efforts regarding international banks and securities firms has matured and accelerated in all respects in 1995. The international trend of regulatory convergence is evident in several respects:

(1) International supervisory cooperation and the coordination of national supervision of international banks and securities firms, the difficulties of which are underscored by inherent gaps in regulatory cooperation and exchange of information, saw the collapse of Barings plc in February 1995; and
(2) The enhancement of risk management and other internal controls, the option of conditional self-regulation, and increased reporting and public disclosure of complex financial activities.

These premises underscore the importance of regulatory convergence for international supervision of international banks and securities firms engaged in transactions involving financial derivatives. The event that provided the necessary momentum for these approaches was the collapse of Barings plc, one of the oldest and most respected banking groups in the United Kingdom, due to losses in

15. Waitzer, *supra* note 14, at 2.
16. *Id.* at 3.

excess of $1 billion sustained primarily by the General Manager of one of its subsidiaries in trading financial derivatives.

This article, consisting of three principal sections, is a survey of joint international and national supervisory efforts regarding financial derivatives in 1995. First, the article examines (utilizing the official U.K. and Singapore reports) in detail the 1995 collapse of Barings plc and the risk management and regulatory issues relating to internal derivatives controls arising from the collapse. Second, this article examines the 1995 undertakings of IOSCO regarding exchange-traded derivatives; and third, the authors evaluate the 1995 IOSCO-Basle Committee joint initiatives regarding the supervision of over-the-counter (OTC) derivatives.

II. Barings, PLC: A Review of the HMSO and Singapore Reports

On February 26, 1995, the High Court of London appointed joint administrators to manage the affairs of Barings plc, the Barings Group parent company, and certain other companies within the Barings merchant banking Group. This appointment resulted in the discovery of massive losses incurred by Barings Futures (Singapore) Pte Limited (BFS), an indirect subsidiary of Barings plc, principally through the unauthorized proprietary trading in exchange-traded financial derivatives by Mr. Nicholas Leeson. Mr. Leeson was acting either alone or in concert as General Manager and Head Trader of BFS on Singaporean and Japanese exchanges.[17]

A. The HMSO Report: Review of the Board of Banking Supervision's Inquiry into the Barings Collapse

On February 27, 1995, the UK Chancellor of the Exchequer announced that he would direct the Board of Banking Supervision (the Board) of the Bank of England (the Bank) to conduct an investigation into the events leading up to the Barings collapse. The Bank's Special Investigation Unit (SIU), comprised of accountants, legal counsel, solicitors, and an expert adviser on derivatives and risk management, assisted the Board. The Board also assessed the performance of the relevant UK supervisors, the Bank of England, and the Securities and Futures Authority (SFA). Only the independent members of the Board conducted this part of the investigation (that is, the three ex officio members of the Board: the Governor, Deputy Governor, and Executive Director of the Bank responsible for Regulation, Supervision, and Surveillance did not particiate).[18] The purpose of the inquiry was, "To establish in detail the events that led to the collapse of

17. *See* HMSO, *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings*, issued 18 July 1995, sec. 1, para. 1.1 [hereinafter HMSO Report].

18. *See* Dr. Maximilian J.B. Hall, *A Review of the Board of Banking Supervision's Inquiry into the Collapse of Barings—Part I*, BUTTERWORTH'S J. OF INT'L BANKING LAW (October 1995), at 421 (Hall I).

Barings; to identify the lessons to be drawn, for institutions, for the Bank's own regulatory and supervisory arrangements, and for the UK system of regulation more generally; and to report to the Chancellor of the Exchequer."[19] The limitations of the inquiry as well as the Board's general inability to access Singaproe documents and Barings employees prevented the Board from (i) determining the motivations and trading strategies behind the unauthorized trading; (ii) verifying all transactions entered through the unauthorized trading account against records held by SIMEX; (iii) excluding the possibility that other Barings employees or third parties participated in this unauthorized trading or in unlawful activities in connection with this trading; (iv) excluding the possibility that the funding of BFS's margin requirements and trading activities resulted from misappropriation of parent company funds; (v) investigating the management's role in the unauthorized trading and the BFS's auditors' work; and (vi) reviewing the adequacy of supervision over BFS by SIMEX or other international regulatory agencies.[20] Nonetheless, the Board produced a rather thorough analysis of the events leading up to the collapse. This analysis is encapsulated in the "HMSO Report."

1. *Introduction: Barings plc*

The HMSO Report findings of fact were somewhat hindered because of the following limitations: Mr. Leeson refused to participate in the inquiry (on advice of his attorneys) while held in custody in Frankfurt, Germany, pending resolution of an application for his extradition to Singapore; the Board did not have adequate access to Barings Group electronic mail messages and taped telephone calls; the Board did not have access to a significant number of documents and witnesses in Singapore; and the Board received no cooperation from the Judicial Managers to BFS, the Singapore Inspectors, the Singapore Ministry of Finance, the Commercial Affairs Department in Singapore, local auditors, and the Singapore Monetary Exchange (SIMEX).[21] However, the Report delineates the principal facts of the collapse.

At the time of the collapse, Baring Brothers & Co., Limited, was the oldest merchant banking business in the City of London. Since the foundation of the partnership in 1762, the partners privately controlled and independently operated the business. In 1890, BB&C Co. succeeded the original partnership and carried on the business of the bank. In November 1985, Barings plc acquired the share capital of BB&C Co. and became the parent company of the Barings Group. In 1991, the Barings Group acquired a 40 percent equity interest in Dillon, Read & Co., Inc., a U.S. investment bank based in New York.[22] BFS, incorporated in

19. HMSO Report, *supra* note 17, at ch. 1, para. 1.2.
20. *Id.* at para. 1.78.
21. *See* Hall I, *supra* note 18, at 421; HMSO Report, *supra* note 17, ch. 1, paras. 1.71-1.74 (delineating in detail the significant limitations on access to documents and individuals).
22. HMSO Report, *supra* note 17, at ch. 1, para. 1.18.

Singapore on September 17, 1986, was an indirect subsidiary of Baring Securities Limited (BSL). BSL was incorporated in the Cayman Islands as a subsidiary of BB&C Co. BSL generally operated through subsidiaries as a broker-dealer in the Asia Pacific, Japan, Latin America, London, and New York markets.[23] Barings originally formed BFS in 1986 to trade financial derivatives on SIMEX as a nonclearing member; and in 1992, BFS became a corporate clearing member of SIMEX. At the time of the collapse, BFS employed Leeson and twenty-three other staff.[24] Mr. Leeson was BFS's General Manager and Head Trader from late 1992 until the collapse. Prior to his move to Singapore in March 1992, Leeson worked for Barings in London in a back office capacity for almost three years.[25] As an international financial conglomerate, Barings sought to control and to manage its operations through a matrix management scheme, wherein managers that are based overseas have local reporting lines of an administrative nature as well as reporting lines to a product manager based in a regional office.[26] Thus, Leeson reported to Barings's BFS management in Singapore, and apparently both Leeson and the Singapore management had reporting lines to the Group-wide support functions in London.[27] According to the findings, this management system created widespread confusion over exactly who was responsible for BFS's trading activities.[28]

2. *Unauthorized and Concealed Trading*

Beginning in mid-1992, BFS executed trades on SIMEX, the Osaka Stock Exchange (OSE), the Tokyo Stock Exchange (TSE), and the Tokyo International Financial Futures Exchange (TIFFE). BFS primarily executed trades in three kinds of financial futures contracts on the aforementioned exchanges: Nikkei 225 stock index futures; ten-year Japanese Government Bond (JGB) futures; the three-month Euroyen contract; and options on these financial futures contracts.[29] SIMEX, created in 1984, developed parallel markets for these futures and options contracts in direct competition with the respective Japanese exchanges. Hence, the different characteristics and rules of the exchanges,[30] such as differing margin requirements, gave rise to advantages for dealing on one exchange in preference

23. *Id.* at para. 1.20.
24. *Id.* at para. 1.33.
25. *Id.* at para. 1.35. A more comprehensive description of Mr. Leeson's career and background is included in the HMSO Report. *See id.* at paras. 2.55-2.60.
26. *Id.* at para. 1.36.
27. *Id.* at para. 1.36.
28. *See, e.g.*, *id.* at paras. 2.51-2.65.
29. HMSO Report, *supra* note 17, at sec. 1, para. 1.37. The market prices of these futures and options contracts are related to the price or value of the underlying Japanese securities. For example, the price of the Nikkei 225 index futures contract is related to the value of the Nikkei 225 index of leading Japanese companies' share prices. For a complete description of these products, *see id.* at Appendix V.
30. *See id.* at ch. 3.

to the other.[31] BFS's original function was to execute trades on an agency or riskless principal basis on behalf of Barings clients, most of whom were actually clients of BSL or Baring Securities (Japan) Limited (BSJ), another subsidiary of BSL. The agency trading purportedly took advantage of pricing differentials in these contracts on SIMEX and the Japanese exchanges. This interexchange arbitrage trading is commonly known as "switching."[32]

The reported profits from BFS's arbitrage trading over 1993-1994 were enormous. Barings's London management was clearly aware of the profitability of Leeson's reported trading activities at BFS. In fact, due to Barings's remuneration policies, many senior members of management and Leeson himself received substantial bonuses as a direct result of these profits.[33] These profits, however, were in reality offset by much greater concealed losses that were actually incurred through unreported and unauthorized trading by Leeson[34] in a client error account created by Leeson on SIMEX, popularly dubbed "account 88888."[35]

The trading conducted by BFS on these exchanges required substantial funding in the form of margin payments to the exchanges to support the positions held by BFS. BB&Co. proivded most of this funding through BSL and BSJ.[36] In sum, BB&Co. funded the unauthorized trading by (i) monies advanced to BFS by BSJ and another subsidiary for what these entities understood to be their own account trading through BFS; (ii) monies advanced by BSL to BFS on BFS's requests for the payment of margin to the exchanges, which were not effectively queried, verified, or reconciled to the trading records of clients; and (iii) the use of artificial trades created to reduce the level of margin calls from SIMEX.[37] Incredibly, Barings's London management purportedly believed until several days before the collapse that the arbitrage trading conducted by BFS was essentially risk-free and extremely profitable.[38] The management purportedly believed that BFS entered into equally offsetting matched positions on particular contracts

31. *Id.* at ch. 1, para. 1.37.

32. *Id.* at para. 1.38.

33. *See, e.g.*, *id.* at paras. 2.81-2.93.

34. A number of devices concealed the unauthorized trading. These devices included the suppression of account 88888 from London management, the submission of falsified reports to London, the misrepresentation of the profitability of BFS's trading, and numerous falsified trading transactions and accounting entries completed by either Leeson himself or the Singapore staff at his direction. *See id.* at ch. 13, para. 13.8.

35. HMSO Report, *supra* note 17, at sec. 1, para. 1.39. *See id.* at para. 4.2 (attributing the responsibility for the trading on and accounting for account 88888 to Leeson, and relying on the observations that (i) he was the senior floor trader throughout 1992-1995, (ii) he was the general manager of BFS responsible for the back office, (iii) someone opened account 88888 shortly before he began to use it for trading, (iv) he took responsibility for arranging funding for the account, (v) staff in Singapore attributed responsibility to him, and (vi) he represented himself to London management as the person who could answer all queries relating to the trading accounts). *See also id.* at para. 4.5 (describing account 88888).

36. *Id.* at sec. 1, para. 1.40.

37. *Id.* at para. 13.7.

38. *Id.* at ch.1, para. 1.41.

on SIMEX and the Japanese exchanges, and reasoned that price movements on the exchanges would not materially affect the net value of the holdings.[39] However, Leeson did not have matched positions, but rather was engaged in enormous unhedged positions.

An internal audit completed in October 1994 raised numerous questions regarding Leeson's activities, including the key fact that he controlled the front and back office functions of BFS's trading.[40] However Barings's London management was not aware of SIMEX's concerns about Barings's financing of client trades[41] and market concerns about the scale of BFS's trading activities until January 1995.[42] These market concerns apparently did not cause management concerns because management thought that Leeson's transactions were fully matched across SIMEX and the Japanese exchanges. By the end of January 1995, however, management apparently ordered Leeson not to increase his positions and, if possible, to reduce them with minimal loss. Leeson never complied.

As of December 31, 1994, and unbeknownst to management, BFS's cumulative proprietary trading losses totaled £208 million.[43] By February 27, 1995, however, these losses increased to £827 million and eventually totaled £927 million after liquidation.[44] The losses primarily stemmed from futures trading in Nikkei 225 index and JGB contracts[45] and unauthorized implied volatility options trading on these contracts.[46] These positions were largely unhedged.[47]

3. *Causes of the Barings Collapse: Management Failures, Inadequate Internal Controls, and Ineffective External Audits*

The Board concluded in the HMSO Report that Leeson's unauthorized and undetected trading activities and the subsequent Barings collapse were chiefly

39. *Id.* at para. 1.41.

40. *Id.* at para. 1.44.

41. *Id.* at para. 1.46.

42. *Id.* at para. 1.45. Barings actually received a telephone call from officials at the Bank for International Settlements (BIS) who heard rumors that Barings had margin losses in the Nikkei futures contracts and could not meet its margin calls. *Id.*

43. *Id.* at ch. 4, para. 4.08.

44. *See id.* at paras. 4.08-4.16.

45. *See id.* at paras. 4.17-4.49.

46. *See id.* at paras. 4.50-4.78. Volatility trading in the options market seeks to take advantage of mispriced options because options become more expensive as market volatility increases. The market benchmark in determining whether options are expensive or cheap is known as "implied volatility." *Id.* at paras. 4.61-4.62. Leeson's apparent option writing strategy followed that of a volatility trader who believed the Nikkei 225 index would move materially from its normal trading range and also believed that implied volatility was accordingly trading at levels that could not be sustained. *Id.* at para. 4.65.

47. *See id.* at paras. 4.71-4.72. The strategy that Leeson followed was not inherently complex and is used by many professional options traders on a daily basis. However, the fact that Leeson did not hedge his portfolio and had no risk management system in place to properly analyze the variables inherent in implied volatility left his positions extremely sensitive to small movements in the market indices. *See id.* at para. 4.76.

due to ineffective risk management and inadequate internal control.[48] The Board specifically emphasized that Barings's management ignored a significant number of warning signs that, if noticed, would have provided them with ample time to remove the Barings Group from the brink of insolvency.[49] These warning signs included:

(1) The lack of segregation of duties in BFS between the front office (trading) and back office (settlement), which the internal audit report identified following the review of BFS's operations in July-August 1994;
(2) the consistently high level of funding required to finance BFS's trading activities;
(3) the unreconciled balance of funds transferred from Barings in London to BFS in Singapore for margin payments;
(4) the apparently high level of profitability of BFS's trading activities compared to the low level of risk as perceived and authorized by London management;
(5) a purportedly unauthorized over-the-counter derivatives transaction entered into by Leeson;
(6) several letters sent to Barings in London by SIMEX that included specific references to account 88888 and sought adequate assurances regarding BFS's ability to fund its margin calls in adverse market conditions;
(7) issues and questions arising out of Barings's reporting of large exposures and client money to supervisors and regulators; and
(8) market concerns about the size of BFS's positions circulating in January-February 1995.[50]

The Board observed that these warning signs were not properly addressed because management and individuals in a number of different departments failed to face up to, or follow up on, specifically identified problems.[51] In sum, the Board emphasized that many important internal controls failed within the Barings Group, especially the supervision of BFS; and that this failure exacerbated the collapse. The respective failures covered management controls, financial controls, operating controls, organizational elements, and business functions.[52] These failures primarily included a lack of segregation of front and back office trading duties in Singapore;[53] the absence of management supervision over Leeson's activities at BFS;[54] inappropriate funding procedures utilized by the Barings Group (parent company and subsidiaries) to BFS, with particular focus on settlements,

48. *Id.* at ch. 13, paras. 13.10-13.11.
49. *Id.* at para. 13.12.
50. *Id.* at ch. 1, para. 1.70.
51. *Id.* at 13.12.
52. *See* Hall I, *supra* note 18, at 423.
53. HMSO Report, *supra* note 17, at ch. 7, para. 7.14; *id.* ch. 13, paras. 13.13-13.15.
54. *See id.* at paras. 7.7-7.13; 13.16-13.21.

credit aspects, and operational financial controls;[55] insufficient responses to warning signals;[56] the absence of risk management and compliance functions at BFS;[57] inadequate follow-up to internal audit recommendations;[58] inadequate reporting to regulators;[59] and inadequate responses by London management to SIMEX inquiries in January 1995.[60]

The Board topped off its analysis of the management and internal control failures in connection with the Barings collapse by recommending the following:

(1) management teams have the duty to understand fully the businesses they manage;[61]

(2) management must clearly establish and communicate the responsibilities for each business activity within the financial intermediary;[62]

(3) clear segregation of front office (trading) and back office (settlement) functions in securities trading is critical to any effective control system;[63]

(4) management must establish relevant internal controls, including independent risk management, for all business activities;[64] and

(5) top management and the audit committee must ensure that significant weaknesses, identified to them by internal audit or otherwise, are quickly resolved.[65]

As for the external auditors, the firms involved in the audits of the Barings Group in London and Singapore from 1992 to 1995 were the local Singaporean firm of Deloitte & Touche (D&T), the London-based firm of Coopers & Lybrand (London) (CLL), and Coopers & Lybrand Singapore, a separate partnership (CLS).[66] D&T audited BFS in 1992 and year-end 1993 and reported to CLL for inclusion of BFS's statements into the Barings Group consolidated financial statements.[67] The Board did not have access to the working papers or employees of D&T in relation to BFS.[68] Hence, the Board passed no judgment on D&T's performance, although by that time the BFS accounts consisted of material misstatements.[69] The Board recognized that CLL, however, duly accepted and relied

55. *Id.* at paras. 7.17-7.23; 13.22-13.35. *See also id.* at ch. 6 (describing BFS funding processes in detail).

56. *Id.* at paras. 7.15; 7.29-7.53.

57. *Id.* at paras. 7.16; 7.25-7.26.

58. *Id.* at para. 7.24; *see also id.* Ch. 9 (discussing July-August 1994 internal audit by Barings Group of BFS).

59. *Id.* at paras. 7.27; 11.30-11.40; 11.86-11.88; and 13.40-13.43. *See also* Ch. 11 (discussion of reporting by Barings to supervisors and regulators).

60. *Id.* at paras. 7.28; 11.97-11.118.

61. *See id.* at ch. 14, paras. 14.8-14.11.

62. *See id.* at paras. 14.12-14.16.

63. *See id.* at paras. 14.17-14.18.

64. *See id.* at paras. 14.19-14.27.

65. *See id.* at paras. 14.28-14.31.

66. *Id.* at ch. 10, para. 10.2.

67. *Id.* at para. 10.7.

68. *Id.* at para. 10.9.

69. *Id.* at para. 13.44.

upon D&T's audit in their audit of Barings's consolidated financial statements for year-end 1993.[70] At the date of the collapse, the CLL audit of the consolidated financial statements of Barings plc as of year-end 1994 was not complete.[71] The audit of BFS's 1994 financial statement by CLS, however, was complete.[72]

Although the Board also did not have access to the working papers or employees of CLS,[73] the Board observed that CLS performed an assessment of BFS's control environment as part of the audit that was complete by November 1994. The CLS audit concluded that the controls within BFS were satisfactory, notwithstanding the lack of segregation between front and back office trading duties.[74] As for CLL, the Board concluded that CLL did not perform sufficient tests to ensure that the controls over payments of margin and the associated accounting balances were operating effectively and otherwise did not diligently follow up on questionable funding procedures.[75] Thus, although the Board could not verify all of the facts in connection with the performance of the external auditors, the auditors clearly did not follow up on issues arising from their respective audits.

4. *The Supervisory and Regulatory Framework for the Barings Group and BFS*

a. The Bank of England

The Bank of England was responsible for the consolidated supervision[76] of the Barings Group.[77] Thus, the Bank received and considered data on Barings's consolidated (group-wide) capital ratios and consolidated large exposures,[78] but was not responsible for the individual supervision of BFS. The Bank is required under the Banking Act 1987, however, to account for risks within the group that might affect the authorized institution (which, in the case of the Barings Group,

70. *Id.* at para. 10.8.
71. *Id.* at para. 13.48.
72. *See id.* at paras. 10.39-10.57 (discussion of facts concerning CLS audit).
73. *Id.* at para. 10.39.
74. *Id.* at para. 13.47.
75. *Id.* at paras. 13.49-13.55.
76. The "consolidated supervision" of a financial group or conglomerate that includes a bank is supervision that assesses the risks to the bank from the activities of other companies in that conglomerate. *Id.* at ch. 12, para. 12.6. This assessment is based on various sources of information, including the consolidated returns covering the group or conglomerate submitted by the bank. *Id.* The Bank of England is obliged to exercise consolidated supervision whenever an authorized institution is a member of a group or conglomerate. *Id.* As the Bank of England originally authorized BB&Co. under the U.K. Banking Act of 1987, BB&Co. was responsible for the consolidated supervision of the Barings Group. *Id.* at para. 12.7.
77. *Id.* at para. 12.7.
78. Section 38(1) of the U.K. Banking Act 1987 is the basis of the Bank's large exposures rules and requires any U.K. authorized institution to notify the Bank before incurring an exposure (that is, a loan or other transaction by which it exposes itself to a loss) to a person of more than 25 percent of its capital base. *Id.* at para. 12.40. The Bank has since supplemented section 38 with two Notices to U.K. banks, the second of which (published in 1993, effective January 1, 1994) superseded the first. *Id.* at para. 12.41.

was BB&Co.).[79] Hence, the Bank facilitates risk analysis on a consolidated basis to capture exposures arising in the authorized institution and other connected subsidiaries, and on an unconsolidated basis to assess the financial position of the authorized institution itself.[80] If the connection between an authorized institution and one of its subsidiaries is particularly strong and certain other criteria are met, the Bank may permit solo consolidation, when the subsidiary is treated as a division of the authorized institution and included in the institution's unconsolidated prudential returns filed with the Bank.[81]

The intent behind consolidated supervision is that the subsidiary should be sufficiently connected to the parent bank that it is treated as the same institution. If necessary, the parent bank should be able to wind up a solo consolidated subsidiary quickly and painlessly in times of financial stress. Consolidated supervision, as a supplement to solo supervision, can set exposure limits for the bank and the group of companies of which the bank is a member.[82] Unless otherwise specified by Bank agreement, the maximum exposure of the bank or the solo consolidated group to the rest of the group cannot be in the aggregate more than 25 percent of the bank's unconsolidated or solo consolidated capital base.[83] This capital requirement is known as the "connected lending limit."

Although the Banking Act does not address lead regulation, one of the recognized supervisors in the UK will act as the coordinating supervisor for each financial group.[84] The lead supervisor coordinates the various regulators for the group. In the case of the Barings Group, the Bank acted as the lead supervisor of the Barings Group.[85] If an institution authorized under the Banking Act also conducts investment business under the Financial Services Act of 1986, the Bank's Memorandum of Understanding (MoU)[86] with other Self-Regulatory Organizations (SROs) gives the Bank primary responsibility for supervising the capital adequacy and financial position of the institution, thus superseding the responsibil-

79. *Id.* at para. 12.7.

80. *Id.* at para. 12.8.

81. *Id.* at para. 12.9. The subsidiary is monitored for capital adequacy and large exposure reporting purposes as if it were part of the institution. The requirements for a bank subsidiary to be solo consolidated with the parent bank are set out in a Bank of England Notice issued in 1993 and include requirements that the management of the solo consolidated subsidiary must be under the effective direction of the parent bank and that no obstacle can impede payment of surplus capital up to the parent bank. *Id.*

82. *Id.*

83. *Id.* at para. 12.10.

84. *Id.* at para. 12.11.

85. *Id.*

86. Each Memorandum of Understanding (MoU) contains formal arrangements for the exchange of information and cooperation in the performance of the Bank's and the relevant SRO's regulatory functions. The general principle embedded in each MoU concerning exchange of information is that of "reporting by exception." Matters are not reported to the other regulator unless they give rise to a concern. *Id.* The specific manner in which MoU's operate depends on the individual agreement, but all are based on the presumption that information must flow freely between supervisors. *Id.* at para. 12.13.

ities of other SROs.[87] The primary SRO involved in the regulation of BFS, with which the Bank maintained such an MoU, was the Securities and Futures Authority (SFA).

b. The Securities and Futures Authority

The Barings Group contained several subsidiaries, notably BSL and BSLL, that were members of the SFA and thus authorized to carry out certain types of investment business in the UK.[88] The SFA directly regulated these firms, while the Bank served as the regulator of their parent company, BB&Co., as the consolidated supervisor. The SFA, an SRO approved by the Securities and Investments Board (SIB), is responsible for authorizing and monitoring firms that carry out investment business as described under the Financial Services Act.[89] In the case of Barings, the SFA was responsible for monitoring that BSL and BSLL had adequate financial resources and protection for customer assets.[90] BFS was a subsidiary of BSL, created for the purpose of trading on SIMEX.

The Financial Services Act, however, does not address the particular extent to which the SFA is required to regulate the operations and financial affairs of a member firm or its subsidiaries.[91] In general, the SFA does not have any obligations to member firm subsidiaries (whether UK or foreign) other than those applicable to ordinary counterparties that expose the member firm to risk.[92] The SFA also does not have any substantial powers with regard to subsidiaries under its rules.[93] Hence, unlike the Bank of England, the SFA does not engage in consolidated supervision of a member firm and its subsidiaries.[94]

However, in the monitoring of the financial resources of BSL, the Board found that the SFA would have relevant information on the financial position of its subsidiaries that could influence the integrity of the member firm.[95] Nonetheless, in relation to subsidiaries of a member firm, the SFA has no power and is under no duty to regulate the business of nonmember firm subsidiaries; and its duties and powers are limited to regulating the investment business of the member firm.[96] Thus, with regard to BFS, a clear regulatory and/or supervisory gap existed, and neither UK regulator would accept direct responsibility for activities conducted through BFS.

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87. *Id.* at para. 12.12.
88. *Id.* at para. 12.104.
89. *See id.* appendix XIV, at paras. XIV.35-XIV.44.
90. *Id.* at para. 12.105.
91. *Id.*
92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.*
96. *Id.* at para. 12.106.

c. The International Supervisory Framework

The concept of "lead supervisor" is recognized internationally in the Basle Concordat issued by the Basle Committee[97] in 1983.[98] The Concordat, as revised, provides the fundamental guidelines for the regulation of international banking groups.[99] The Bank of England and the Japanese Ministry of Finance (MoF)[100] are participating members of the Basle Committee. The MoF, which supervised the Tokyo and Osaka branches of BSJ (one of the principal funding mechanisms for BFS's trading activities), did not issue a supervisory order or take any administrative action against BSJ with regard to the Barings collapse.[101]

Banking supervisors that are not official members of the Basle Committee have formed committees similar to the Basle Committee. These committees usually represent a particular geographic area or interest group.[102] The Monetary Authority of Singapore (MAS) is a member of the Offshore Group of Banking Supervisors. In a May 1995 letter to the Board, the MAS indicated that its supervision of BFS entailed ". . . the review of their financial returns and audit reports, including SIMEX's . . . inspection reports and the proposed disciplinary actions to be taken against member firms. MAS conducts on-site inspections of merchant banks. The on-site inspections of futures . . . firms are conducted by SIMEX."[103] The MAS letter clarified that SIMEX was the SRO authorized by the MAS for futures trading firms and, as such, was responsible for ensuring that its member firms such as BFS complied with the prescribed rules and regulations of the exchange.[104] With regard to BFS, SIMEX exercised its primary oversight functions through on-site inspections and general surveillance of BFS's activities on SIMEX.[105] The Board further observed that SIMEX inspected BFS in April 1993 and September 1994 and that BFS was either fined or in the process of being fined by SIMEX for violations of exchange rules. SIMEX clearly stated its concern with BFS's operational errors, apparent financing of customer trades, and aggressive market positions on several occasions, only to be reassured by Barings officials that any problems envisaged with BFS would be resolved.[106]

97. The Basle Committee consists of the central banks and banking regulators of the G-10 countries plus Switzerland and Luxembourg. The Committee generally meets four times per year to foster cooperation between banking regulators and establish minimum standards for the supervision of international banking groups. *Id.* at para. 12.14.

98. The Basle Concordat, as supplemented in 1990 and 1992, balances responsibilities between the parent and host supervisory authorities for the regulation of foreign subsidiaries or branches of respective parent banks. *Id.* at para. 12.14.

99. *Id.* at para. 12.14.

100. For a background on regulation in Japan, *see id.* appendix XIV, at paras. XIV.66-XIV.75.

101. *Id.* at para. 12.165.

102. *Id.* at para. 12.15.

103. *Id.* at para. 12.160.

104. *Id.* For a background on SIMEX, *see id.* appendix XIV, at paras. XIV.47-XIV.65.

105. *Id.* at 12.161.

106. *Id.* at para. 12.162.

In 1987, the Basle Committee and the Offshore Group of Banking Supervisors entered into a Document of Understanding that addressed certain aspects of international coordination between bank supervisors of their respective groups. Thus, the Concordat and the Document of Understanding provide for the supervision of international banking groups. The Board asserted that the principles of these documents are as follows:

(1) effective supervision of banks' foreign establishments requires a sharing of responsibilities between host and parent authorities and contact and cooperation between them;
(2) host and parent authorities should try to satisfy themselves that banks' internal controls include comprehensive and regular reporting between foreign establishments and the head office;
(3) if a host authority suspects material problems in a foreign establishment, the host should inform the parent authority; and if serious problems arise in a foreign establishment, the host authority should consult with the parent authority to seek possible remedies;
(4) host authorities should ensure that adequate data can flow to parent authorities, particularly in relation to large exposures;
(5) when a host authority discovers an exposure that should be drawn to the attention of the parent authority, the host authority should do so;
(6) host authorities are responsible for foreign establishments operating in their territories, while parent authorities are responsible for them as part of larger banking groups; such responsibilities are both complementary and overlapping; and
(7) consolidated supervision does not reduce host authorities' responsibilities for foreign establishments operating in their territories.[107]

Unfortunately, the Board did not have the opportunity to make adequate findings of fact to draw conclusions on how these various supervisors interacted and coordinated with respect to the Barings collapse. However, the limited findings make clear that information between the Singaporean and UK regulators regarding concerns over BFS's trading activities was grossly inadequate.

5. *Supervisory Performance and Future Implications*

a. The Bank of England

The Board conducted an in-depth review of the performance of the UK supervisory authorities in relation to the Barings collapse. The Board initially noted that the Bank of England, although not fully knowledgeable of the early warning signs of which Barings management was aware, was nonetheless aware that Barings's East Asian trading activities required a high level of funding; that these trading activities resulted in a reported high profitability;

107. *Id.* at para. 12.16. *See also id.* appendix XIV, paras. XIV.15-XIV.27.

that Barings's management believed them to be risk-free; and that Barings's reporting to the Bank of its consolidated large exposures on the OSE and SIMEX was problematic.[108] The Board then identified two of the more important issues in the Bank's supervision of Barings. One issue was whether the Bank failed (given the scale of the BFS arbitrage operation in Singapore and Japan, the sums involved, and the importance of the trading profits to the Group) to take sufficient steps to assure that this supposedly risk-free operation did not in reality pose a threat to BB&Co.[109] Another issue was whether the Bank failed to pursue diligently the outstanding questions regarding Barings's large exposure to OSE and the Bank's grant of an informal large exposure concession to Barings while questions remained.[110] Other issues of high significance were the allowance of solo consolidation of BSL with BB&Co. soon after a major corporate restructuring of the Barings Group and the connected lending limit concession granted to Barings;[111] the subject matter and scope of the reporting accountants[112] reports regarding Barings;[113] and the international coordination between the Bank, SFA, and overseas regulators in relation to Barings.[114]

In addressing these issues, the Board recognized that the Bank was the consolidated supervisor of the Barings Group and the lead regulator of BB&Co.,[115] and that the Bank regarded the controls in Barings as "informal but effective."[116] Thus, the Board found that such a degree of confidence in Barings senior management entitled the Bank to greater reliance on management's statements and representations.

Further, the Board found that the Bank did not review Barings's overseas subsidiaries. Instead, the Bank relied on the auditors and reporting accountants' statements regarding the existence of the connected lending limits on BB&Co.'s exposure to the overseas securities subsidiaries. The Bank also relied on the supervision of BFS by the relevant overseas regulators.[117]

Interestingly, the Bank's consolidated supervision extended to other Barings Group subsidiaries insofar as their activities would affect BB&Co.[118] However, the Board found that the Bank was entitled to rely on these authorities.[119] The Board, however, criticized the Bank's supervisory performance as follows:

108. *Id.* at para. 12.20.
109. *Id.* at para. 12.22. *See also id.* at paras. 12.36-12.39; 12.88.
110. *Id.* at para. 12.22. *See also id.* at paras. 12.40-12.65.
111. *Id.* at para. 12.22. *See also id.* at paras. 12.66-12.88.
112. Under section 39 of the Banking Act 1987, the Bank can require an authorized institution to commission a report from reporting accountants on any matter about which it can require information under the Act. *See id.* at para. 14.52.
113. *Id.* at 12.23. *See also id.* at paras. 12.89-12.101.
114. *Id.* at para. 12.23. *See also id.* at paras. 12.102-12.103.
115. *Id.* at para. 13.57.
116. *Id.* at para. 13.58.
117. *Id.* at para. 13.58.
118. *Id.* at para. 13.59.
119. *Id.* at para. 13.60.

(1) the Bank should have understood Barings's East Asian operations and the degree of control that Barings in London exercised over those operations;[120]
(2) the Bank incorrectly granted an informal concession to Barings's large exposure limits in allowing the Group's OSE exposures to exceed the 25 percent of capital base limit;[121]
(3) the Bank incorrectly delayed a decision concerning whether or not to withdraw the informal concession until February 1, 1995[122] (although the Board was unable to determine whether this delay was a contributory factor to the eventual Barings collapse);[123] and
(4) the Bank displayed a lack of rigour in the solo consolidation of BSL with BB&Co., which resulted in BSL's inclusion in the unconsolidated returns submitted by BB&Co. to the Bank and in BSL's treatment as one with BB&Co. for capital adequacy and large exposure policy.[124]

The Board then evaluated how the Bank's existing arrangements for the supervision of financial groups with substantial operations outside of the banking sector (such as Barings) should be improved.[125] For instance, the Board addressed the Bank's consolidated supervision of banking groups by recommending that the Bank:

(a) supplement its traditional collection of data from banking groups concerning their consolidated capital adequacy and large exposures by increasing its understanding of the nonbanking businesses undertaken by those banking groups;[126]
(b) obtain a more comprehensive understanding of how Group Management controls the risks in those businesses;[127]
(c) clearly define its relationship with other regulators and effectively coordinate with them;[128]
(d) prepare internal guidelines that identify those parts or activities of a banking group that pose material risks to the bank and delineate the steps the staff should take to assess and monitor risks;[129]

120. *Id.* at para. 13.61. The Board did observe that no guidelines or systems appeared to be in place within the Bank to determine whether a member of a banking group for which the Bank was responsible for consolidated supervision was in a situation that could affect the financial soundness of the bank. *Id.*

121. *Id.* at paras. 13.63-13.64.

122. *Id.* at paras. 13.64-13.65.

123. *Id.* at para. 13.66.

124. *Id.* at paras. 13.67-13.70.

125. *Id.* at para. 14.33.

126. *Id.* at paras. 14.34-14.35.

127. *Id.* at para. 14.35.

128. *Id.* at para. 14.35.

129. *Id.* at para. 14.36.

(e) arrange for meetings with Group management and overseas regulators concerning foreign operations of banking group subsidiaries;[130]
(f) understand the key elements of the management and control structures of the supervised banking groups;[131]
(g) extend the scope of consolidated returns that are currently submitted to include more information about the businesses and their profitability as a whole;[132] and
(h) ensure that the senior management of banking groups clearly understands and openly acknowledges their responsibility for the accuracy of consolidated returns, and ensure that such returns are signed by a senior director of the bank.[133]

Also, the Board addressed the solo consolidation of BSL with BB&Co. and initially observed that because of the failure of controls in Barings following such solo consolidation, funds that as a matter of law constituted loans by BB&Co. to BSL passed to BFS without limit.[134] Hence, the Board concluded that the solo consolidation of any active trading entity with a bank should require the formal approval of an Executive Director of the Bank or one of the Bank's Governors.[135]

Moreover, the Board recommended solo consolidation only if every solo consolidated entity is supervised and only when practical; the controls within all of the proposed solo consolidated entities are adequate to ensure that exposures to companies outside the solo consolidated group are controlled; and the Bank has the means to receive, on a continuing basis, suitable reassurance regarding such controls.[136] Finally, the Board recommended that the Bank prepare internal guidelines for its staff as to the procedures for granting solo consolidation and the supervision of the solo consolidated group.[137]

The Board emphasized that the Bank should continue to develop international coordination among G-10 banking supervisors;[138] work closely with internal Audit Committees of banking groups on a regular basis;[139] require major banks to commission reports on their systems of control over the accuracy of the information in the records and to work with the accountancy profession to increase the standards of reports;[140] and promptly investigate any repeated or significant breaches of the large exposure rules.[141] Interestingly, the Board did not recom-

130. *Id.*
131. *Id.* at para. 14.37.
132. *Id.* at para. 14.38.
133. *Id.* at para. 14.39.
134. *Id.* at para. 14.40.
135. *Id.* at para. 14.42.
136. *Id.*
137. *Id.* at para. 14.43.
138. *Id.* at paras. 14.44-14.46.
139. *Id.* at paras. 14.47-14.48.
140. *See id.* at paras. 14.52-14.55.
141. *Id.* at para. 14.57.

mend that the Bank engage in regular on-site examinations of such banks, opining without clarification that a ". . . number of disadvantages [are] associated with this kind of approach."[142]

b. Securities and Futures Authority

In considering the SFA, the Board initially observed that the SFA did not consider the activities or financial position of the subsidiaries of BSL.[143] The Board, however, concluded that the SFA's responsibility for monitoring a member firm's obligation to maintain adequate financial resources to meet its commitments and to contain its risks required SFA supervision of the activities and solvency of that firm's subsidiaries insofar as they are capable of affecting the financial integrity of the member firm.[144] Thus, the Board criticized the SFA's failure to understand the significance of BSL's operations in Singapore or the level and nature of BSL's funding of BFS's trading activities.[145]

The Board then concluded that, due to this gap in understanding and supervision, the SFA needed to clarify its responsibilities in connection with companies related to an SFA member firm, especially when the SFA is a party to an MoU with the Bank of England and the Bank is the lead regulator.[146] In addition, the Board set out a number of further matters for the SFA to take into account in their own regulatory arrangements, such as:

—assessing the extent to which the SFA communicates with overseas regulators of companies related to member firms;

—adopting the recommendations made to the Bank concerning communications with internal auditors and Audit Committees;

—instituting a system of regular meetings with management of member firms; and

—instituting a system of reviews by reporting accountants similar to that of the Bank.[147]

B. The Singapore Inspectors' Report on Baring Futures (Singapore) Pte Ltd.

On March 9, 1995, following the collapse and purchase of much of the Barings Group by the Dutch financial conglomerate Internationale Nederlanden Groep (ING), the Singaporean Minister for Finance under Section 231 of the local Companies Act appointed two partners of Price Waterhouse to investigate the

142. *Id.* at para. 14.51.
143. *Id.* at para. 13.75.
144. *Id.*
145. *Id.* at para. 13.77.
146. *See id.* at appendix VIII (Memorandum of Understanding Between the Securities and Futures Authority and the Bank of England on the Financial Supervision of Banks).
147. *See id.* at appendix XV.

affairs of BFS and to report their findings to the Minister.[148] The Inspectors, assisted in part by local solicitors and the British law firm of Clifford Chance, carried out the investigation and delivered the report to the Minister for Finance on September 6, 1995.[149] The Inspectors limited their analysis in the Singapore Report to a detailed reconstruction of the facts, circumstances, and causes of the collapse of BFS and the Barings Group.[150] Although the Inspectors did not focus on investigating any fraud or collusion by Leeson, they did have an opportunity to review many of the relevant documents and to assess the conduct of many of the relevant officers and employees of the Baring Group and BFS.[151] The Singapore Report designated many issues that had a significant impact on the collapse of the Barings Group, some of which were entirely different from those examined by the Board of Banking Supervision.

These issues included:

(1) whether the organizational structure and controls were weak, particularly with respect to Leeson, which resulted in ineffective monitoring or control of his activities;[152]

(2) to what extent the internal audit identified warning signals that ought to have alerted the Baring Group to the need to monitor and control Leeson more closely;[153]

(3) to what extent the Compliance Department was responsible for checking Leeson and his activities;[154]

(4) to what extent a proper system monitored the Baring Group's risk exposure and the role of the Asset and Liability Committee (ALCO) consisting of Barings Group executives;[155]

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148. *See* Baring Futures (Singapore) Pte Ltd., The Report of the Inspectors Appointed by the Minister for Finance (issued Sept. 6, 1995) (hereinafter the Singapore Report).

149. *See* Maximilian J.B. Hall, *A Review of the Singapore Inspectors' Report on Baring Futures (Singapore) Pte Ltd.*, BUTTERWORTH'S J. OF INT'L L. (December 1995), at 525 (hereinafter Hall III).

150. *Id.* at 525; Singapore Report, *supra* note 148, ch.1 , para. 1.14.

151. Singapore Report, *supra* note 148, at ch. 1, para. 1.15.

152. *See id.* at para. 2.40(i). *See also id.* at paras. 4.3-4.12 (merger of BSL and BB&Co.); para. 4.27 (describing dangers inherent in utilization of matrix management scheme); paras. 4.28-4.30 (describing Leeson's control of both the front and back office functions); paras. 4.31-4.34 (describing inadequate management coordination over BFS's activities and confusion over proper reporting lines).

153. *Id.* at para. 2.40(ii). *See also id.* at paras. 5.32-5.34 (reviewing internal audit findings of numerous warning signals but recognizing the failure to initiate action on such findings).

154. *Id.* at para. 2.40(iii). *See also id.* at para. 6.4 (compliance officer denying that she had responsibility over BFS's activities); para. 6.7 (acceptance of front running in trading for clients by BFS); para. 6.14 (recognizing that, given compliance officer's limited view of the scope of her duties, Leeson could not have felt restrained in his trading activities).

155. *Id.* at para. 2.40(iv). *See also id.* at paras. 7.5-7.8 (observing that no independent risk and compliance officer existed in Singapore for BFS); paras. 7.9-7.30 (describing duties and responsibilities of ALCO); paras. 7.31-7.37 (observing that ALCO clearly did not serve its purpose as a risk and control committee with regard to BFS).

(5) how did BSL Settlements identify and resolve the concerns that stemmed from Leeson's activities;[156]
(6) how did Group Treasury deal with the funds requested by Leeson to maintain his trading positions;[157]
(7) what were the roles of Financial Controls and Credit Control in relation to Leeson's activities;[158]
(8) to what extent the Financial Products Group and its senior managers may have contributed to Leeson's ability to function in the way that he did;[159]
(9) how the events escaped the supervisory reporting regime;[160] and
(10) to what extent external controls may have been negated.[161]

In considering each of these issues, the Singapore Report reviewed the documents, parties, and corporations involved to a far greater extent than the Board's HMSO Report. The Singapore report also directed and/or apportioned fault to certain individuals under each issue.[162] In many instances, the Inspectors directly questioned the credibility of the management they interviewed against the background of facts. The Inspectors especially suspected of a cover-up by Barings' senior management, a possibility accepted by the HMSO Report but not fully explored because of limited access to personnel and information.[163] In most other respects the Singapore Report reaffirmed the findings of the HMSO Report, including those findings related to the supervisory performance of the Bank of England. The Singapore Report also supported its conclusions with extensive factfindings.

In other respects, however, the Singapore Report surpassed the HMSO Report in criticizing SIMEX for having concerns about BFS's activities, not following up on them with urgency, and not informing the Monetary Authority of Singapore

156. *Id.* at para. 2.40(v). *See also id.* at para. 8.35 (observing that the failure of BSL Settlements to avert the collapse of the Barings Group was "condemnable").

157. *Id.* at para. 2.40(vi). *See also id.* at Ch. 9 (details of Group Treasury's activities in relation to the collapse).

158. *Id.* at para. 2.40(vii). *See also id.* at paras. 10.22-10.24 (observing that the Group Finance Director did not adequately perform his duties and that he was aware of warning signals regarding BFS but failed to follow up on them); *id.* at para. 11.12 (observing that if Credit Control attempted to analyze the funds remitted to BFS or the clients who purportedly received advances, Leeson's activities would have been exposed).

159. *Id.* at para. 2.40(viii). *See also id.* at paras. 12.20-12.24 (observing that although Leeson had control of both the front and back offices of BFS, management should have questioned the credibility of such high profits from arbitrage activities and understood the nature of the activity to make sufficient inquiries).

160. *Id.* at para. 2.40(ix). *See also id.* at ch. 13.

161. *Id.* at para. 240(x). *See also id.* at chs. 14-15.

162. For an excellent summary of these voluminous findings, *see* Hall III, *supra* note 149, at 526-27.

163. *See id.* at 527-28 (reviewing findings of the Singapore Report in this regard).

(the central bank of Singapore) of these concerns;[164] being insufficiently sensitive to the risks associated with the very large volume of business transacted by BFS and overly liberal in granting increases in position limits;[165] and failing to diligently initiate enforcement actions against BFS, relying instead on the parent institution's reputation or on foreign regulatory authorities supervising the activities of the head office of such an institution.[166] Finally, the Singapore Report observed that SIMEX was implementing a comprehensive risk management program to prevent the accumulation of unacceptable risk exposure in the Exchange and to ensure that clearing members have sufficient financial resources to support their positions.[167] Singapore also amended the Futures Trading Act, effective on April 1, 1995, to strengthen the supervision of futures.[168]

C. The ING Acquisition

Barings plc, the parent company, and a number of other Barings Group companies went into joint receivership on February 26, 1995, following BFS's enormous trading losses. The Administrators and the Bank of England soon approved a bid for most of the Barings Group companies by ING, and the acquisition received final approval in the High Court in London on March 6, 1995.[169] In the acquisition, ING agreed to cover the Leeson trading losses and to inject £660 million into the Group's operations, but declined to acquire the holding company.[170] All Barings Group creditors, except subordinated bondholders with holdings of £100 million, were fully compensated, but the shareholders received nothing.[171] Initially, ING retained all staff, including those in the Singapore offices of BFS, although in May 1995, ING dismissed twenty Barings executives involved in the crisis.[172] After BFS's failure to meet a margin call on February 27, 1995, SIMEX successfully petitioned the Singapore High Court to place BFS with Judicial Managers.[173] In addition to the investigations by the MAS Inspectors, the SFA and SIMEX both conducted independent investigations of their own. As of this writing (March 1996), the SFA inquiry into the Barings collapse was not complete.

164. *Id.* at para. 15.41.
165. *Id.* at para. 15.42.
166. *Id.* at para. 15.43.
167. *Id.* at para. 15.46.
168. *Id.* at para. 15.47.
169. *See* Dr. Maximilian J.B. Hall, *A Review of the Board of Banking Supervision's Inquiry into the Collapse of Barings—Part II*, BUTTERWORTH'S J. OF INT'L BANKING LAW (November 1995), at 472 (Hall II).
170. *Id.*
171. *Id.*
172. *Id.*
173. *Id.* at 473.

III. International Initiatives in the Supervision of Exchange-Traded Derivatives (Post-Barings): The Windsor Declaration (May 1995)

In direct response to the Barings collapse and its implications on the regulation of exchange-traded futures markets, the leading international futures authorities met at Windsor, England, in May 1995 to address many of the problematic issues raised by the collapse. The historic meeting and the ensuing Windsor Declaration called for increased cooperation in regulation and exchange of information among the futures authorities. The SIB and the U.S. Commodity Futures Trading Commission (CFTC) jointly hosted the meeting. The meeting's delegates, including representatives of the Technical Committee of IOSCO and the regulatory bodies from sixteen countries responsible for supervision of the world's leading futures exchanges (including the MAS and MoF), endorsed the issuance of a Declaration outlining the steps they proposed to strengthen the supervision of the international futures markets.[174] Not surprisingly, these steps addressed many of the issues raised in the HMSO and Singapore Reports. In particular, the authorities agreed to support, subject to appropriate confidentiality protections, mechanisms to improve prompt communication of information relevant to material exposures and other regulatory concerns; review the adequacy of existing arrangements to minimize the risk of loss through insolvency or misappropriation and to enhance such arrangements when appropriate; promote national provisions and market procedures that facilitate the prompt liquidation and/or transfer of positions, funds, and assets, from failing members of futures exchanges; and support measures to enhance emergency procedures at financial intermediaries, market members, and markets and to improve existing mechanisms for international cooperation and communication among market authorities and regulators.[175] The futures authorities proposed further cooperative efforts in issues related to international cooperation between market authorities; protection of customer positions, funds, and assets; default procedures; and regulatory cooperation in emergencies.[176]

Further, the futures authorities agreed to promote:

(1) active surveillance within each jurisdiction of large exposures by market authorities and/or regulators;
(2) the development of mechanisms to ensure that customer positions, funds, and assets can be separately identified and protected;
(3) enhanced disclosure by the markets of the different types and levels of

174. *See* Securities and Investment Board Press Release No. 3845-95, *SIB and CFTC Chairmen Welcome Windsor Declaration* (May 17, 1995). The regulators attending the Windsor Meeting included the relevant futures authorities of Australia, Brazil, Canada, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Singapore, South Africa, Spain, Sweden, Switzerland, United States, and the United Kingdom. *See Windsor Declaration, infra* note 175, at Annex 1.

175. *See Windsor Declaration*, sec. I, at 2 (May 17, 1995) (on file with the Banking & Finance Law Unit, Centre for Commercial Law Studies, University of London).

176. *Id.* sec. II, at 4.

protection of customer funds and assets, particularly when they are transferred to different jurisdictions and through omnibus accounts;

(4) record-keeping systems at exchanges and clearing houses;

(5) enhanced disclosure by exchanges to participants of the rules and procedures governing default and the treatment of positions, funds, and assets of member firms and their clients in the event of such a default;

(6) the immediate designation by each regulator of a contact point for receiving information or providing other assistance to other regulators and/or market authorities and the means to ensure twenty-four hour availability of contact personnel in the event of a disruption at a financial intermediary, market member, or market;

(7) review of existing lists and assuring maintenance by IOSCO of an international regulatory contacts list; and

(8) the development by financial intermediaries, market members, or markets and regulatory authorities of contingency arrangements, or a review of the adequacy of existing arrangements.[177]

Finally, the authorities jointly recommended that the IOSCO Technical Committee further consider various issues related to cooperation between market authorities; protection of customer positions, funds, and assets; default procedures; and regulatory cooperation in emergencies.[178] At the IOSCO Annual Meeting in July 1995, all IOSCO members endorsed the Windsor Declaration.[179]

Notable post-Barings initiatives regarding exchange-traded derivatives also occurred at the national level in 1995. For example, in November 1995 the Office of the Comptroller of the Currency (OCC) of the United States announced new guidelines for examiners on derivatives related to futures brokerage activities. The guidelines, issued as a direct result of the Barings collapse, apply to national bank subsidiaries that operate as futures commission merchants (FCMs) registered with the CFTC.[180]

IV. International Initiatives in OTC Derivatives Supervision: 1995 IOSCO-Basle Committee Joint Reports

A. IOSCO-Basle Committee Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms (May 1995)

The release of the Windsor Declaration, which focused on the international coordination of the exchange-traded derivatives markets, coincided with the re-

177. *Id.* at 3.

178. *Id.* at sec. III.

179. *See* Press Release, *IOSCO Moves on Windsor Declaration*, in Public Documents of the XXth Annual Conference of the International Organization of Securities Commissioners (IOSCO), Paris, 13 July 1995, TOME 2, No. 41, at 2.

180. *See* OCC News Release No. 95-122, OCC Issues Derivatives Guidance for Bank Examiners on Futures Brokerage, OCC NR 95-122 (Nov. 9, 1995), available on LEXIS.

lease of a report jointly authored by the IOSCO Technical Committee and the Basle Committee in May 1995 entitled *Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms* [hereinafter the Joint Derivatives Report]. This initiative represented a combination of the efforts individually undertaken by IOSCO and the Basle Committee in July 1994, wherein they each issued very similar risk management guidelines for derivatives under a common press release.[181] The Joint Derivatives Report concentrated on the task of improving and harmonizing supervisory reporting of OTC derivatives activities.[182]

The overall supervisory information framework advanced in the Joint Derivatives Report consisted of two components: a catalogue discussing data that the Committees identified as important for an evaluation of derivatives risks and that supervisors may choose from as they expand their reporting systems, and a common minimum framework of data elements to which relevant supervisory authorities should have access.[183] The Joint Derivatives Report provided that national supervisors, in monitoring the activities of large international financial institutions involved in significant derivatives activities, must be satisfied that the institution in question has the ability to measure, analyze, and manage risks from both a qualitative and quantitative standpoint. The quantitative elements of the supervisory focus include obtaining and evaluating institution-specific information on credit risk, liquidity risk, market risk, and earnings from derivatives activities.[184] In considering these risks and factors, the Joint Derivatives Report continuously stressed that supervisors must distinguish between exchange-traded and OTC derivatives activities in identifying the information needed for supervisory assessment.

The qualitative elements of the supervisory focus, on the other hand, would include obtaining and evaluating information concerning the specific institution's systems, policies, and practices for measuring and managing the derivatives risks and, most importantly, information on the risk limits that banks and securities firms use to manage their exposures and any changes in these limits.[185] The Joint Derivatives Report identified the major institution-specific risks inherent

181. *See* Basle Committee and Technical Committee of IOSCO (Joint Report), Framework for Supervisory Information about the Derivative Activities of Banks and Securities Reports (May 1995) (Joint Derivatives Report). This Joint Report draws from the following: IOSCO Technical Committee, Working Party No. 3, *Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms* (July 1994); and Basle Committee on Banking Supervision, *Prudential Supervision of Banks' Derivatives Activities* (Dec. 1994). These guidelines are an official adaption and reinforcement of the approach suggested earlier by the industry itself in the Group of Thirty (G-30) Report. *See* Group of Thirty, *Derivatives: Practices and Principles* (1993).

182. Schioppa, *supra* note 7, at para. 10.

183. Joint Derivatives Report, *supra* note 181, at sec. I, para. 4.

184. *Id.* at sec. II, para. 17.

185. *Id.* at para. 18.

in derivatives activities and the quantitative and qualitative factors and methods of assessment of these factors that national supervisors should consider in evaluating such institutions.

1. *Credit Risk*

The Joint Derivatives Report defined credit risk as the risk that a derivatives counterparty may fail to fully perform on its financial obligations. Credit risk is of greater concern in OTC derivative contracts because, with exchange-traded derivatives, the various exchanges have clearing houses for derivative transactions and use risk management systems that substantially mitigate credit risks to their members.[186] The Joint Derivatives Report segregated the credit risk analysis into the following five components.

a. Current Credit Exposure

The Joint Derivatives Report defined "current credit exposure" as the measurement of the cost of replacing the cash flow of OTC derivative contracts with positive mark-to-market value if the counterparty defaults on its obligations.[187] This cost is called the replacement cost. The Report recognized that legally enforceable bilateral netting agreements can significantly reduce the amount of credit risk to counterparties and can extend across different derivative product types.[188] Hence, the Report concludes that an institution's current credit exposure is best measured as the positive mark-to-market replacement cost of all derivative products on a counterparty-by-counterparty basis, thus accounting for bilateral netting agreements.[189]

b. Potential Credit Exposure

The Joint Derivatives Report recognized that prudent analysis should focus on replacement cost at given points in time and on its potential to change over time. Hence, "potential credit exposure" is defined in the Report as the exposure of the OTC derivative contract that may be realized over the remaining maturity due to movements in the rates or prices of the underlying.[190] As recent amendments to the 1988 Basle Capital Accord guidelines for credit risk already incorporate potential OTC derivatives credit exposure for banks,[191] the Joint Derivatives

186. *Id.* at paras. 20-21. Both futures and options exchanges typically mark derivative exposures to market each day. Futures exchanges eliminate exchange members' exposures to the clearing house through variation margin payments. Regarding options exchanges, clearing house exposures to written options are fully collateralized. *Id.* at para. 20 n.5.

187. *Id.* at para. 22.

188. *Id.*

189. *Id.*

190. *Id.* at para. 24.

191. In April 1995, the Basle Committee issued final rules regarding capital requirements for exposure to credit risk in transactions involving OTC derivatives, which amend the 1988 Capital Accord. *See* Basle Committee on Banking Supervision, *Basle Capital Accord: Treatment of Potential Exposure for Off-Balance Sheet Items* (Apr. 1995). Credit risk is addressed in the sense of treatment

Report opined that supervisors should base their assessments on this data.[192] However, the Report also recognized that most large banks and securities firms have sophisticated simulation models to evaluate potential credit exposures more precisely, but that such models are dependent upon and influenced by the parameters used in the model.[193] The Joint Derivatives Report suggested that if supervisors decide to allow such institutions to use their own internal models to gauge this exposure, they should discuss the parameters of the various models to ensure an appropriate level of understanding and confidence in the use of such models.[194]

c. Credit Enhancements

The Joint Derivatives Report recognized that information on credit enhancements used in connection with OTC derivative transactions is important to the assessment of credit risk in OTC derivative positions. Such credit enhancements are normally in the form of collateral or initial margin payments held against the current exposure of derivative contracts with counterparties, and may effectively reduce credit risk.[195] The Report opined that the quality and marketability of such collateral, and whether this collateral is in excess or equal to the institution's netted current exposure to that counterparty, is particularly important to the supervisors in this regard.[196]

d. Concentration Risk

The Joint Derivatives Report defined this risk as the significant counterparty OTC derivatives credit exposure relative to the institution's capital base. The Report suggested that supervisors identify and focus upon the ten largest counterparties to which individual institutions are exposed and whether they present netted current and potential credit exposure above a certain predetermined threshold.[197] The Report also recommended that supervisors limit counterparty exposure to an aggregated basis (not limited to single types of derivative instruments), taking into account the nature and scope of interinstitutional off-balance sheet relationships; and that supervisors monitor concentration risks such as and overex-

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of potential exposures to OTC derivatives contracts by recognizing the risk-reducing effects of enforceable netting arrangements between counterparties. The treatment of OTC instruments such as forward contracts, swaps, purchased options, and other derivatives merit special consideration with regard to credit risk and market risk in the treatment of potential exposures under capital adequacy regimes.

192. *Id.* In the Basle Capital Accords, potential credit exposure is measured by the add-on, which is calculated as: [Kx gross or effective notional principal] × [conversion factor based upon the volatility of the underlying]. Effective notional principal may be obtained by adjusting the notional amounts to reflect the true exposure of derivative contracts that are either leveraged or otherwise enhanced by the structure of the transaction. *Id.* at para. 24 n.6.

193. *Id.* at para. 25. These models are generally based upon probability analysis and simulation models that estimate the volatility of the underlying and the expected movements of the underlying on the derivative contract over time. *Id.*

194. *Id.* at para. 25.

195. *Id.* at para. 26.

196. *Id.* at para. 27.

197. *Id.* at para. 28.

posure of counterparties to certain exchanges and issues and within certain business sectors, countries, or regions.[198]

e. Counterparty Credit Quality

The Joint Derivatives Report recognized that credit risk is dependent upon both the credit exposure to the counterparty and the probability of the counterparty's default, and this recommended that supervisors focus on the current and potential credit exposure to counterparties of various credit quality and the respective probabilities of credit loss.[199] The Report further recommended that supervisors consider bilateral netting agreements, credit ratings assigned by rating agencies, credit enhancements used by counterparties, or the institution's internal credit evaluation system, to make such assessments.[200]

2. *Liquidity Risk*

The Joint Derivatives Report identified two basic types of liquidity risk associated with derivative instruments: market liquidity risk and funding risk.[201]

a. Market Liquidity Risk

Market liquidity risk is defined in the Report as the risk that supervisors take that a derivatives position cannot be eliminated by either liquidating the instrument or establishing an offsetting position. Again, the Report suggested that supervisors distinguish between exchange-traded and OTC derivative instruments because market illiquidity differs between OTC and exchange-traded markets due to the customized nature of some OTC derivative contracts.[202] These contracts often include fundamental elements or combinations of market risk that cannot be easily replicated using the more standardized exchange-traded contracts or OTC contracts.[203]

The Joint Derivatives Report recommended that supervisors further segregate market liquidity risk into market values of derivative contracts by type, maturity, and the availability of alternative hedging strategies or substitute instruments.[204] In addition, the Report recommended that supervisors understand the particular derivatives markets in which they are participating, especially in the case of OTC derivative contracts, because these markets often involve contracts tailored to the specific needs of clients and the process of marking-to-market is normally more difficult for these contracts than for the standardized and liquid exchange-traded contracts.[205] The Joint Derivatives Report further recognized that unwind-

198. *Id.* at paras. 29-30.
199. *Id.* at para. 31.
200. *Id.*
201. *Id.* at para. 32.
202. *Id.* at para. 33.
203. *Id.* at para. 33 n.8.
204. *Id.* at para. 33.
205. *Id.* at para. 34.

ing OTC derivative positions quickly would, in most instances, be more difficult than for exchange-traded positions.[206]

b. Funding Risk

The Joint Derivatives Report defined funding risk as the risk that derivatives activities will place adverse funding and cash flow pressures on an institution. The Report advised that funding risk is best considered on a consolidated basis across all financial instruments, including but not limited to derivative contracts.[207] The Report again differentiated between OTC and exchange-traded derivative contracts, given the requirements for margin and daily cash settlement for exchange-traded instruments and the ensuing demands for liquidity that large positions in such instruments could mandate.[208] The Joint Derivatives Report suggested that, in addressing funding risk, supervisors should also consider the following factors: the inclusion of collateral or margin requirements in OTC derivative contracts for assessing liquidity risk; information concerning the expected cash flows and timing of those flows over the life of derivative instruments; OTC derivative contracts' subjection to any triggering agreements;[209] institutions' sensitivity analyses of the effect of adverse market developments on their funding requirements; and the provision of additional collateral or margin calls in these contracts.[210]

3. *Market Risk*

The Joint Derivatives Report defined market risk as the risk that the value of on- or off-balance sheet positions will decline before the positions can be liquidated or offset with other positions. The Report suggested that supervisors assess information on market risk by product type for the entire institution, and further considered these risks to be relative to the market risks of other instruments, individual portfolios of clients specializing in nonstandardized OTC derivative contracts, and proprietary and nonproprietary trading and dealing.[211] The Joint Derivatives Report recommended that supervisors could alternatively consider position data that would allow for independent supervisory assessment of market risk through

206. *Id.*

207. *Id.* at para. 35.

208. *Id.* at para. 36. The primary example is when significant positions in OTC derivative contracts are hedged with exchange-traded contracts. *Id.* This occurs in the OTC derivative markets to a large extent.

209. "Triggering agreements" generally contain contractual provisions that require the liquidation of the contract or the posting of additional collateral if certain events, such as credit downgrading by a credit agency, occur over the life of the contract. If an institution assumes larger positions in OTC contracts with such agreements, this change could increase funding risk by requiring the liquidation of contracts or the pledging of additional collateral when the institution is already experiencing financial stress. *Id.* at para. 37.

210. *Id.* at paras. 36-38.

211. *Id.* at para. 39.

the use of a supervisory model or monitoring criteria and data derived from an institution's own internal estimates of market risk.[212]

The Joint Derivatives Report further advised that for institutions whose derivatives activities are end-user rather than dealer oriented, supervisors should probably consider position data by product type or from a supervisor-derived framework.[213] As alternatives to evaluating position data, the Report suggested that supervisors evaluate information on an institution's internal market risk estimates, such as from their internal value-at-risk models[214] or other information on earnings-at-risk,[215] duration or gap analysis, scenario analysis, or other approaches.[216] Supervisors should evaluate the institution's internal models by comparing past estimates of risk with actual results and by assessing the major assumptions included in the parameters of the given models.[217]

Finally, the Joint Derivatives Report recommended that supervisors ensure that institutions with large trading activities subject their portfolios to regular stress tests using various assumptions and scenarios.[218] Supervisors should perform worst case scenarios on an institution-wide basis with identification of the major assumptions used in the test.[219] Supervisors are directed to consider both quantitative information generated by these tests and qualitative information regarding the actions that management would take under particular scenarios.[220] To minimize regulatory burden, the Report suggests that supervisors focus on obtaining information that is already required under alternative rules to minimize burdens of regulatory compliance.

The Basle Committee and IOSCO already endorse these recommendations in

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212. *Id.* at paras. 39-40.

213. *Id.* at para. 41.

214. "Value-at-risk" models involve the assessment of potential losses due to adverse movements in market prices of a specified probability over a defined period of time. *Id.* at para. 42.

215. Under mark-to-market accounting, value-at-risk will equal earnings-at-risk, as changes in value are reflected in earnings. If accrual accounting is applied to certain positions, value-at-risk and earnings-at-risk will differ because earnings would not reflect all changes in value. *Id.* at para. 42 n9.

216. *Id.* at para. 42. In evaluating value-at-risk models, supervisors should evaluate both the methodology and the main parameters of the model, including (i) the volatility (both implied and historical) and correlation assumptions of the model, (ii) the holding period over which the change in portfolio value is measured, (iii) the confidence interval used to estimate exposure, and (iv) the historical sample period over which risk factor prices are observed. *Id.* at para. 43. However, because static value-at-risk measurements would not provide information as to the relative speed at which derivative positions can be modified, the Joint Report recommended that supervisors require institutions to communicate information on the highest value-at-risk number.

217. *Id.* at para. 44. The Report of the Euro-Currency Standing Committee entitled *Public Disclosure of Market and Credit Risks by Financial Intermediaries*, issued in September 1994 (the Fisher Report), discusses factors to consider in interpreting value-at-risk measures. *Id.* at para. 44 n10.

218. *Id.* at para. 45.

219. *Id.*

220. *Id.* at para. 45. The Report provided that examples of scenarios for interest rate risk include a parallel yield curve shift of a determined amount, a steepening or flattening of the yield curve, or a change of correlation assumptions. *Id.*

their separate capacities. The Basle Committee proposed (April 1995)[221] and issued final rules (January 1996)[222] amending the 1988 Capital Accord to provide for particularized capital requirements for exposure to market risk in transactions. These final rules provide that international banks can either develop and adhere to their own internal value-at-risk models, subject to certain conditions and parameters imposed by supervisors, or follow a standardized approach developed by the Basle Committee. The IOSCO Technical Committee similarly issued a report considering the implications of increased use of value-at-risk models by securities firms,[223] and in the United States the Derivatives Policy Group also developed standards based on the use of such models.

4. *Impact on Earnings*

Perhaps the most controversial aspect of the Joint Derivatives Report is the recommendation that supervisors obtain information on the profitability of derivatives activities and related on-balance sheet positions from institutions and then separate the income of derivatives trading activities from other dealing-related activities.[224]

a. Trading Purposes

The Joint Derivatives Report recommended that, just as sophisticated market participants should view cash and derivative instruments as ready substitutes and the management of both is often aggregated, supervisors should separate trading revenues according to risk classes (that is, interest rate risk, foreign exchange risk, and commodities and equities exposures) without regard to the type of instrument producing the trading income. This separation would enable supervisors to better understand the level of overall trading risk of the institution.[225] Moreover, the Report recommended that supervisors classify income from com-

221. *See* Basle Committee on Banking Supervision, *Proposal to Issue a Supplement to the Basle Accord To Cover Market Risks* (Apr. 1995); Basle Committee on Banking Supervision, *Planned Supplement to the Capital Accord To Incorporate Market Risks* (Apr. 1995); Basle Committee on Banking Supervision, *An Internal Model-Based Approach To Market Risk Capital Requirements* (Apr. 1995).

222. *See* Basle Committee on Banking Supervision, *Amendment to the Capital Accord To Incorporate Market Risks* (Jan. 1996).

223. *See* IOSCO Technical Committee, *The Implications for Securities Regulators of the Increased Use of Value at Risk Models by Securities Firms*, in Public Documents of the XXth Annual Meeting of the International Organization of Securities Commissions (IOSCO), Paris, 13 July 1995, TOME 2, No. 39.

224. Joint Derivatives Report, *supra* note 181, at para. 47. As accounting standards and valuation techniques either differ among countries or regulatory (or lack of regulatory) schemes, the Joint Report recognized that such information would probably not be comparable across jurisdictions. *Id.* at para. 48.

225. *Id.* at para. 49. If the systems of banks or securities firms do not already accomplish this segregation of trading income, the Joint Report suggested simplifying assumptions to approximate the segregation. *Id.* at para. 50.

plex instruments exposed to both interest rate and foreign exchange risks according to the primary substance of exposure of the instrument.[226]

To better evaluate an institution's performance relative to its risk profile, the Joint Derivatives Report suggested the further segregation of trading income within each risk category into origination revenue; credit spread revenue; and other trading revenue.[227] Material trading losses within a particular risk category would thus indicate deficiencies in an institution's risk management system in that category.[228]

b. Purposes Other Than Trading

The Joint Derivatives Report advised that supervisors should evaluate information related to end-user derivatives holdings and focus especially on the effect of reported earnings on off-balance sheet positions held by the institution to manage interest rate or foreign exchange risk.[229] To determine whether certain derivative instruments are in fact being used for risk management purposes, the Report recommended that this information be measured with information on other factors affecting net interest margins and interest rate sensitivity.[230]

c. Identifying Unrealized or Deferred Losses

The Joint Derivatives Report recommended that supervisors establish mechanisms to detect the material accumulation of unrealized losses or losses that are realized but deferred by the institution. Recognition of such material accounting losses prior to their required reporting could indicate deficiencies in an institution's internal controls and accounting systems.[231]

d. Derivatives Valuation Reserves and Actual Credit Losses

The Joint Derivatives Report recommended that supervisors monitor (i) an institution's valuation reserves established for derivatives activities; and (ii) substantial credit losses on derivative instruments suffered during the period. This information would be used to evaluate how adverse changes in derivatives risks would affect an institution's financial condition and earnings.[232]

The Report concluded by recommending that member supervisors choose their regulatory approaches from the common minimum framework catalogue of data items listed above for large internationally active banks and securities firms with significant derivatives activities. The common minimum framework would represent a baseline of information important for supervisors to use in assessing the nature and scope of an institution's derivatives activities and how derivative

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226. *Id.* at para. 50.
227. *Id.* at para. 51.
228. *Id.*
229. *Id.* at para. 52.
230. *Id.*
231. *Id.* at para. 53.
232. *Id.* at para. 54.

instruments contribute to an institution's overall risk profile.[233] The Report suggested that such a common minimum framework could support the efforts of the Euro-Currency Standing Committee of G-10 Central Banks to regularly collect aggregate market data on the derivatives activities of financial institutions, the disclosure of which could serve useful supervisory functions.[234]

B. IOSCO-Basle Committee Report on Public Disclosures of Trading and Derivatives Activities of Banks and Securities Firms and Accompanying Recommendations (November 1995)

The May 1995 Joint Derivatives Report established the basic international framework for the supervision of financial derivatives activities of large financial groups. This framework represents the international basis for the development of quasi-uniform standards, and against which national supervisory guidelines will be considered. However, national and international supervisors, as well as shareholders and other investors of the banks and securities firms engaged in significant derivatives activities, must have the appropriate information to consider the extent of their derivatives risks. Thus, although improved regulatory and public disclosure of derivatives activities could never replace international supervision, improved disclosure is a "most important support" to supervision by international supervisory authorities.[235] The objectives of supervision can be reinforced through the public disclosure of information about how a bank's or securities firm's trading activities contribute to its overall risk profile and profitability and how well the bank or securities firm manages the risks arising from these activities.

Moreover, enhanced disclosure will provide the bank or securities firm with a detailed picture of the risk profile of its counterparties, resulting in improved risk management procedures over time. Improved disclosures of risk profiles can also lessen the opportunities for market rumors and misunderstandings by other market participants in periods of financial stress.

Prior to November 1995, the common minimum regulatory reporting framework envisaged by the IOSCO Technical Committee and the Basle Committee focused on credit risk and the overall market activities of an institution's trading and derivatives businesses.[236] However, in issuing the Joint Report on Public Disclosure of the Trading and Derivatives Activities of Banks and Securities Firms in November 1995 (hereinafter the Disclosure Report), these Committees extended the reporting framework from regulatory reporting to the public disclosure of credit risk and trading and derivatives activities and the market risks

233. *Id.* at sec. III, para. 56. *See also* Annexes 3 & 4, *infra* (tabular information of the suggested common minimum framework for supervising derivatives activities of financial institutions).

234. *Id.* at para. 57.

235. Schioppa, *supra* note 7, at para. 15.

236. *Id.* at para. 15.

they present. The Committees intended for the Disclosure Report to provide internationally active banks and securities firms with the type of information provided by their peers at the international level and with recommendations for further improvements in banks' and securities firms' public disclosures about their trading and derivatives activities.[237]

The Disclosure Report provided an overview of the trading and derivatives-related disclosures of large G-10 international banks and securities firms in their 1994 annual reports on a consolidated basis,[238] and made recommendations for further improvements in disclosure practices. The institutions reviewed consisted of sixty-seven banks and twelve securities firms, with primary focus on institutions as dealers, rather than end-users, of derivatives.[239] These institutions represented the largest banks and securities firms involved with derivatives in their countries, as measured by the total notional amounts of derivative instruments.[240] Disclosures by these institutions differed widely in the level of quantitative disclosure and in discussion of the scope of trading and dealing activities.

In reviewing these disclosures, the Disclosure Report emphasized succinct, illuminating disclosures about the major risks managed by an institution and the potential impact of these risk management activities on earnings. The Disclosure Report asserted that disclosures improved in general compared to similar 1993 annual reports. In particular, a number of international financial institutions provided quantitative information on market risk exposures drawn from their internal risk management systems, more information on credit risk exposures, and expanded management discussions of trading and derivatives activities.[241]

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237. Disclosure Report at (Executive Summary). The recommendations drew on the concepts developed in the *Discussion Paper on Public Disclosure of Market and Credit Risks by Financial Intermediaries* (the Fisher Report), released by the Euro-currency Standing Committee of the G-10 central banks in September 1994 and on the *Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms* released jointly by the Basle Committee and IOSCO Technical Committee in May 1995.

238. Disclosure on a consolidated basis is essential to an understanding of the overall trading and derivatives activities of a bank or securities firm. However, the Joint Report emphasizes that for purposes of evaluating an institution's credit risk or other aspects of a counterparty's risk profile, the financial condition of individual subsidiaries and affiliates within the consolidated group is very important. *Id.* sec. II, at 3. A majority of the large dealer institutions have derivatives subsidiaries or affiliates that are overcapitalized and maintain a AAA credit rating even when the parent may not be similarly rated.

239. *Id.* sec. II, at 4.

240. Again, the internationally active banks and securities firms covered in the Joint Report do not include the subsidiaries of those entities. Hence, Luxembourg banks are not included in the analysis, since the large dealers and end-users of derivatives located in Luxembourg are subsidiaries of banks centered in other G-10 countries. *Id.* at 4 n.7. Moreover, in many jurisdictions sampled, the largest institutions involved in securities activities are either universal banks or majority-owned subsidiaries of internationally active banks.

241. *Id.* at 5. Thus, in order to avoid double-counting, the securities firm section of the Joint Report focused on the stand-alone securities firms of the United States and Japan. Finally, the Report excluded the securities firms in France, Italy, the Netherlands, Spain, and one major U.S. broker-dealer, CS First Boston, Inc., as firms in those countries and CS First Boston, Inc., are

The Disclosure Report recognized, however, that significant differences in levels of required disclosures existed across jurisdictions, and that some major institutions continued to disclose very little about their derivatives activities. The Report suggested that differences in detail and content of public disclosures could be attributed to a number of factors, including statutory provisions and other national standards and requirements for accounting and disclosure; the informational needs communicated by investors, creditors, and other professionals; differences between public disclosure and reporting to supervisors; and the importance of derivatives activities to a particular firm's overall business activity.[242]

Nonetheless, the Report recognized that most of the institutions similarly employed risk measurement and management systems that generated information for use by corporate management and the board of directors; and provided supervisors with extensive information, often on a confidential basis, about their trading and derivatives activities through periodic reports, on-site examinations, and discussions with senior management. For instance, as part of the Derivatives Policy Group's "Framework for Voluntary Oversight," the major U.S. securities firms that are derivatives dealers acknowledged that they are providing to U.S. supervisors detailed credit risk and market risk information on the OTC derivatives activities in their unregulated entities.[243]

The majority of the institutions disclosed derivatives activities on a consolidated basis in two main sections of the annual report: Management's Discussion and Analysis (MD&A) and the annual financial statements, with footnotes presenting data both in narrative and tabular form.[244]

1. *Qualitative Information*

The Disclosure Report stated that a majority of institutions discussed in some form the various risks associated with their trading and derivatives activities and their processes for controlling their exposures and provided a general discussion of the objectives and strategies of their trading. Institutions identified the management groups responsible for setting trading policies and described the managerial functions responsible for ensuring policy compliance. In addition, a majority of institutions discussed in some detail the accounting policies for derivative transactions in the 1994 annual reports, and more than half of the institutions provided a discussion of the methods and assumptions used in valuation of complex financial instruments, including derivatives. Although more than half of the institutions discussed measurement and control of credit and market risks, far less than half of the institutions provided a discussion of the control of operating

subsidiaries of bank holding companies. *Id.* As such, these entities are included as applicable in the disclosure analysis for the large, internationally active banks, as are the securities activities of the major universal banks in the G-10 countries. *Id.*

242. *Id.* at 5.

243. *Id.*

244. *Id.* at 6.

and legal risks. And very few institutions discussed whether or not they used leveraged derivatives contracts.[245]

2. *Quantitative Information*

The Disclosure Report observed that institutions continued to expand the financial reporting of derivatives activities in their annual reports. First, almost all of the institutions identified the notional amounts of their derivatives holdings and provided further instrument detail on their derivatives positions.

Second, almost half of the banking institutions and all of the securities firms identified their trading derivatives positions. Most banks distinguished between exchange-traded and OTC contracts, and the securities firms generally identified and qualitatively described the trading characteristics of derivative instruments (listed versus over-the-counter) within the context of an overall discussion of the firm's business products and services.

Third, almost half of the banks and securities firms provided either a combined maturity schedule (trading and nontrading positions) of their derivatives holdings or a maturity schedule for trading positions.

Fourth, less than half of the banks but all of the securities firms distinguished trading account assets from trading account liabilities, and a significant number of banks and securities firms disclosed the derivatives and cash instruments held for trading purposes at year-end.

Fifth, for the first time, a small number of banks and securities firms provided reporting period averages for the market values of their derivatives and cash instruments held in the trading account.

Finally, institutions continued to provide more information about their nontrading derivatives activities.[246]

a. Credit Risk

A significant number of banks provided more information on credit risk, particularly in relation to the risk-based capital credit-equivalent amounts of derivatives.[247] For example, with respect to securities firms, the most significant increase in credit risk disclosure was in the area of counterparty credit quality. Moreover, almost half of the banks provided information concerning gross positive market value or gross replacement cost without including the risk-reducing benefits of netting arrangements or collateral, as well as current credit exposure.[248] Also, a significant number of banks and securities firms provided information on the credit quality of their derivatives portfolios along with a breakdown of their derivatives credit exposure either by rating agency gradations, internal ratings,

245. *Id.* at 6-7.
246. *Id.* at 8.
247. *Id.* at 9.
248. *Id.*

or for banks, by categories similar to those of the 1988 Basle Capital Accord. Further, almost half of these institutions published information concerning credit exposure concentrations for their derivatives portfolios, in some instances by industry and/or geographical concentration.

However, only a small number of banks separately identified their potential credit exposure,[249] provided a measure of the volatility of credit exposure[250] arising from derivatives, reported the value of collateral and other credit enhancements connected with their trading and derivatives activities, or reported information about their derivatives losses or nonperforming contracts.[251]

b. Market Risk: Trading and Nontrading Activities

The Disclosure Report recognized that one of the most important changes in 1994 disclosures was the provision by eighteen institutions of quantitative information drawn from their risk management systems on their exposures to market risk.[252] The majority of institutions disclosing market risk exposures used the value-at-risk approach, combining cash and derivative instruments. Almost half of these institutions provided daily value-at-risk graphical data, and others provided an average value-at-risk estimate for the 1994 reporting period. A number of banks and securities firms differentiated in their disclosures between proprietary and client-related trading activities, and others provided the information by broad underlying risk factors. Banks provided information of the statistical assumptions and aggregation criteria underlying their value-at-risk estimates, and a number of them also provided for the first time information on the actual changes in the value of the portfolios to which the value-at-risk estimates applied to enable report users to gauge performances in managing market risk exposures.

The major U.S. securities firms, as part of the Derivatives Policy Group's "Framework for Voluntary Oversight" on OTC derivatives, provided to U.S. supervisors on a quarterly basis measures of "capital-at-risk," defined as the maximum loss expected to be exceeded with a probability of 1 percent over a two-week period. These firms also provided the results of a series of core risk factor stress tests of their OTC derivatives portfolios.[253]

The most common nontrading derivatives activities disclosures the banks reviewed that used derivatives for nontrading purposes involved schedules of notional amounts, maturities, and, for swaps, contractual rates paid and received.[254] In addition, the most prevalent means of conveying how derivatives are used to

249. *Id.*
250. *Id.*
251. *Id.*
252. *Id.* at 10.
253. *Id.*
254. *Id.* at 11.

manage interest rate risk of banks was a gap position schedule,[255] used by almost half of the banks reviewed. However, very few banks furnished quantitative information on their value-at-risk measures related to nontrading derivatives, disclosed the duration of derivatives held for risk management purposes, or identified whether the derivatives related to specific components of the balance sheet or to management of overall risk exposure.[256]

c. Earnings: Trading and Nontrading Activities

The Disclosure Report found that a significant majority of the banks and securities firms provided information on the impact of their trading activities on earnings, but very few institutions reported their trading income by risk category, line of business, cash-market, and derivative instruments combined, or type of derivative instrument. However, a number of banks and securities firms distinguished between earnings from cash instruments and from derivatives portfolios.[257]

Eleven banks disclosed the details of how derivative instruments that are held for nontrading purposes affected accrual-based accounting income and expense.[258] A similar number of banks and half of the securities firms reported the overall net effect on net interest margins of their nontrading derivatives activities, and several fewer banks disclosed deferred gains or losses on nontrading derivatives or on when deferrals would be reflected in future earnings. Finally, eighteen banks and three securities firms disclosed the unrealized gains and losses associated with nontrading derivatives positions.[259]

3. *Disclosure Report Recommendations*

The Committees' recommendations followed two principal themes. First, institutions should base enhanced disclosures on information drawn from their own internal risk management and measurement systems. Enhanced disclosures should enable financial statement users to assess a firm's performance in managing material exposures to credit risk, market risk, liquidity risk, and the impact of trading and derivatives activities on earnings.[260] Second, institutions should provide financial statement users with transparent disclosure on their trading activities and overall involvement in the OTC and exchange-traded derivatives markets;

255. Gap position schedules disclosed by banks organize financial assets and liabilities according to maturity in a number of time intervals. The difference between assets and liabilities in each time interval (gap or net exposure) forms the basis for assessing interest rate risk. Derivatives of various maturities can be used to adjust the net exposure of each time interval to alter the overall interest rate risk of the institution. *Id.* at 11 n.9.

256. *Id.*

257. *Id.* at 11.

258. When instruments are not marked to market with gains and losses recognized in income, but are instead accounted for on a historical cost basis. *Id.* at 11.

259. *Id.* at 11-12.

260. *Id.* sec. III, at 13.

the impact of these activities on earnings; their performance in managing risk in trading these instruments; and qualitative disclosures presenting an overview of an institution's overall business objectives, risk-taking philosophy, how trading and derivatives activities fit into these overall objectives, and the internal control mechanisms in place to manage these activities.[261] The Committees also encouraged institutions to consider the common minimum framework presented in the May 1995 Joint Derivatives Report as a basis for these disclosures.[262]

a. Qualitative Disclosures

In particular, the Disclosure Report advocated that banks and securities firms provide key summary information concerning specific risk management controls and accounting and valuation methods. Regarding specific risk management controls, the Report urged disclosures of organizational structure and internal controls for trading and derivatives activities, major risks and the processes used to manage and measure these risks, the specific trading and derivatives activities, descriptions of nontrading derivatives activities, and high-risk instruments such as leveraged derivatives.[263] Regarding accounting and valuation methods, the Report urged disclosures of the accounting policies, methods of income recognition applicable to trading activities, standards used for derivatives activities (such as termination of contracts, hedge accounting, and balance sheet netting of derivatives transactions), the valuation methodologies used, and whether adjustments are made after positions have been marked-to-market.[264]

b. Quantitative Disclosures

The Disclosure Report further urged disclosures of market activity, credit risk, and market liquidity inherent in an institution's trading and derivatives activities. This disclosure would include information about the composition of trading portfolios, involvement in the OTC and exchange-traded derivatives markets, credit risk and market liquidity for derivatives contracts, whether derivatives are used for trading or nontrading (hedging) purposes, counterparty credit quality and the existence of credit enhancements, nonperforming derivatives contracts and losses sustained from such trading, and internal methodologies used to collect and evaluate these types of information.[265]

The Report focused on two primary areas of disclosure in this regard: market risk and earnings. First, with regard to disclosures related to the measurement and management of market risk, dealer banks and securities firms should produce daily information on profits and losses on their trading activities for internal risk management purposes.[266] Quantitative disclosures related to market risk should

261. *Id.* at 13-14.
262. *Id.*
263. *Id.*
264. *Id.* at 15.
265. *Id.* at 16-17.
266. *Id.* at 17.

include discussion of the major assumptions and parameters necessary to understanding an institution's market risk disclosures.[267] Second, with regard to disclosures related to earnings, the Report urged disclosures on all related issues and a discussion of the accounting principles used.

The Report asserted that the lack of harmony in accounting standards should not preclude significant disclosure of institutions' risk management activities, as such disclosures convey information that current national accounting conventions may not yet provide.[268] The Report referred institutions to the Joint Derivatives Report for appropriate items of disclosure under earnings from trading and derivatives activities.[269]

V. Concluding Observations

The Barings collapse represents a textbook example of a systemic breakdown among the internal controls of a financial group; the failure of respected national supervisory authorities to carry out their mission; and the failure of national supervisors to coordinate and exchange information on a cross-border basis to prevent the collapse of a well-respected banking group. Directors and officers of international financial intermediaries can draw many lessons from this incident.

The crucial failure of internal controls in this example was the lack of separation of front office (trading) and back office (settlement) functions at BFS. This lack of separation is the principal reason that Leeson avoided detection for so long. In sum, sound internal risk management procedures and simple inquiries by management would have revealed the existence of Leeson's concealed account and consistent losses accumulated therein, as well as the enormous unhedged positions taken by Leeson across the Asian exchanges over January-February 1995.[270]

The Barings collapse immediately called into question the Bank of England's unwillingness to bail out the Barings Group using public funds; the damage done to the reputation of the City of London as an international financial center; and the Bank of England's post-Barings decision to overhaul its style of supervision, especially in its decision to avoid regular on-site inspections of banking groups

267. *Id.*

268. *Id.* at 18.

269. *Id.*

270. For example, if positions are hedged, then derivatives contracts or positions running into deficit should be offset by futures contracts showing a surplus. As the negative positions must be covered by margin payments in exchange-traded derivatives, surpluses should exist in the hedged contracts and the net margin payment should always be close to zero. If the Barings management simply checked whether or not the other derivatives contracts had unrealized surpluses, the surpluses would have indicated that the supposedly offsetting or matched contracts were not entered into and hence positions were unhedged. *See* John Board, Charles Goodhart, Michael Power, and Dirk Schoenmaker, *Derivatives Regulation*, Special Paper No. 70, London School of Economics and Political Science Financial Markets Group (March 1995), at 14.

(as opposed to the U.S. federal banking regulators).[271] The HMSO and Singapore Reports concerning the Barings collapse encapsulate a saga of failed internal controls and risk management of financial conglomerates that regulators should closely study as they refine national and develop international risk management agendas for financial groups.

A more troubling point, however, is that this systemic breakdown of both national and international supervision could occur such a short time after the BCCI crisis. The destabilizing effects of that collapse, although perpetrated by massive fraud, money laundering, and other criminal activities, could also have been uncovered much earlier if national banking and securities regulators practiced effective international supervisory coordination of such cross-border financial groups.[272]

The HMSO and Singapore Reports made clear that, just as in the BCCI incident, international coordination and cooperation were ineffective until the true damage was complete. The BCCI and Barings Group crises taken together mandate that international coordination and cooperation in the supervision of financial conglomerates, especially those utilizing the matrix management scheme, are equally as important as national supervisory efforts.

The regulatory fallout from the BCCI and Barings collapses has certainly accelerated this process, which officially began in 1993 when the Basle Committee and IOSCO joined forces to supervise international financial conglomerates and published separate papers on this subject.[273] In early 1993, at the initiative of the Basle Committee, an informal Tripartite Group of banking, securities, and insurance regulators (an informal group with representatives from each of the G-10 countries, Luxembourg, and the European Commission) examined supervision of financial conglomerates.[274] In July 1995, the Tripartite Group released a report entitled "The Supervision of Financial Conglomerates" (the Tripartite Report),[275] the purpose of which is to synthesize the views of the Tripartite Group

271. Hall II, *supra* note 169, at 473.

272. For a detailed inquiry into the BCCI crisis, *see* HMSO Report, Return to an Address of the Honorable the House of Commons, *Inquiry into the Supervision of the Bank of Credit and Commerce International* (Oct. 22, 1992).

273. *See* Basle Committee on Banking Supervision, *The Supervision of Financial Conglomerates*, text included in report number 8 on *International Developments in Banking Supervision* (Sept. 1992); International Organization of Securities Commissions, *Principles for the Supervision of Financial Conglomerates* (Oct. 1992). Several other supervisory and regulatory groups within the financial community have explored the regulation of financial conglomerates. *See* Banking Advisory Committee of the Commission of the European Communities, *Financial Conglomerates*, XV/1008/92-EN-Rev.1 (Oct. 21, 1992); Working Group of the Conference of Insurance Supervisors of the European Economic Community, *Financial Conglomerates* (Apr. 9, 1992); The Insurance Committee of the Commission of the European Communities, *Financial Conglomerates*, XV/2009/93 (Feb. 15, 1994).

274. Schioppa, *supra* note 7, at para. 11.

275. *See* THE SUPERVISION OF FINANCIAL CONGLOMERATES: A REPORT BY THE TRIPARTITE GROUP OF BANKS, SECURITIES AND INSURANCE REGULATORS (issued July 1995) (hereinafter Tripartite Report).

members, to identify problems that financial conglomerates pose to supervisors, and to consider ways in which these problems could be resolved. Many of the views expressed by the Board of Banking Supervision in the HMSO Report are directly reflected in the Tripartite Report.

Notwithstanding the supervision of financial conglomerates, the Barings collapse also triggered much more extensive discussions regarding the international supervision of financial derivatives. Overall, the HMSO and Singapore Reports emphasized that the breach of internal guidelines and the failure of internal risk management controls caused the Barings collapse, not the misuse of financial derivatives. Although the trading of financial derivatives per se did not cause the Barings collapse, the leverage involved in unhedged futures and options positions unquestionably resulted in much greater levels of risk than simple interexchange arbitrage. This leverage accelerated the losses incurred by the Barings Group by over £600 million over January-February 1995 alone.

In terms of an evolving international supervisory framework, both the Joint Derivatives Report and the IOSCO-Basle Disclosure Report will undoubtedly serve as valuable international guidelines for national supervisors to utilize in regulating their respective issuers. However, a primary point left untouched by the Disclosure Report was the extent of disclosure that should be required from end-users of OTC derivatives, and whether the standards applicable to major international OTC derivatives dealers should extend to end-users whose derivatives activities are significant enough to warrant such disclosure.

The U.S. Securities and Exchange Commission (SEC) has taken the initiative in December 1995 and proposed several amendments to SEC Regulations requiring disclosures of derivatives activities by registrants. These proposals are directly in line with the IOSCO-Basle Committee Disclosure Recommendations.[276] After conducting a series of reviews of the annual statements of over 500 corporate issuers, the SEC apparently concluded that enhanced disclosure of derivatives activities was necessary at both the dealer and end-user levels.[277]

In general,[278] the proposed SEC amendments require disclosure of derivatives activities from several perspectives. For example, the Release proposes clarification and expansion of existing requirements for financial statement footnote dis-

276. *See* Proposed Amendments to Require Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Qualitative and Quantitative Information About Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments, and Derivative Commodity Instruments, Securities Act Release No. 33-7250, Securities Exchange Act Release No. 34-36643, 1995 SEC LEXIS 3464 (Dec. 27, 1995) [hereinafter Disclosure Release].

277. *See* Disclosure Release, *supra* note 276, 1995 SEC LEXIS 3464, at *6-7.

278. The Disclosure Release is a complex document full of terms of art, including U.S. accounting terms, and is specifically tailored to other existing SEC rules and regulations. The summary in this article is only a summary. For a complete analysis, see the Release itself.

closures for certain derivative instruments if a given registrant engages in significant or material[279] derivatives activities.[280]

Also, the SEC Release would require disclosure outside the financial statements of qualitative and quantitative information concerning market risk inherent in such instruments. The qualitative disclosures would focus on either the fair values of such instruments or the potential loss in future earnings, fair values, or cash flows of such instruments from "reasonably possible market movements."[281] Further, the Release would require enhanced disclosure of derivatives activities that affect other reported items and discussion of these effects in the Management's Discussion and Analysis (MD&A)[282] section of the disclosure documentation.[283] The Release would purportedly require derivatives disclosures of both U.S. and foreign registrants.

In conclusion, the Windsor Declaration and the IOSCO-Basle Committee joint reports are premised upon improved international coordination and cooperation in the regulation of exchange-traded and OTC derivative contracts and the strong desire to avoid the collapse of another large financial group. Exchange-traded derivatives, such as those involved in the Barings crisis, are traded on exchanges regulated either by SROs of the exchange itself, subject to the oversight supervision of other supervisory authorities, or by the supervisory authorities themselves. These regulations provide for the trading of standardized futures and options contracts OTC derivatives; clearance and settlement of trades through a central clearinghouse, often with rules specifically designating margin requirements upon its members to ensure the liquidity of trading and the mitigation of credit risk in the clearinghouse; exchange rules whereby officials can ensure the financial stability of members; and exchange rules governing the actual trading of derivatives, including antifraud rules, antimanipulation rules, related provisions, and position limits. For example, such rules on SIMEX allowed for exchange officials and other supervisors to liquidate the BFS portfolio in an orderly fashion without causing systemic disruption in trading on the exchange or neighboring Japanese exchanges due to the massive exposures that Leeson's trading incurred. If BFS maintained a large OTC, as opposed to an exchange-traded derivatives portfolio, the impact of its failure would have been quite different on the rest of the international financial community.

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279. The materiality of derivatives activities, as proposed in the Release, would be measured by the fair values of DFI and DCI at (i) the end of the reporting period; and (ii) during the reporting period. *Id.* at *7. "Fair value" is defined in the Release to have the same meaning as the term is defined by U.S. generally accepted accounting principles (GAAP). *See* FASB, Statement of Financial Accounting Standards No. 107, *Disclosures About Fair Value of Financial Instruments* (FAS 107) (Dec. 1991), at para. 5.

280. 1995 SEC LEXIS 3464, at *7.

281. *Id.* at 3464, *7-8. For the definition of "fair value" as set out in the Release, *see supra* note 279.

282. *See, e.g.*, Item 303 of Regulation S-K, 17 CFR s. 229.303 (1995).

283. 1995 SEC LEXIS 3464, at *9-10.