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The Developing Legal and Regulatory Status of Foreign Currency Options: A Comparative Study

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In this paper the dynamic growth during the 1980s of both exchange and over-the-counter markets in foreign currency options is outlined. The relevant regulatory structures of U.S., U.K. and Japanese law are compared, and the author argues in particular that the so-called Treasury Amendment of the U.S. Commodity Exchange Act excludes the over-the-counter currency options market from regulatory jurisdiction and that this remains the proper policy choice. Finally, the legal doctrines of impossibility and the currency of damages are explored in the currency options context from a comparative point of view.

I. Introduction

The explosive growth of the foreign currency options markets during the 1980s is perhaps the single most important development of the decade in the foreign exchange marketplace. As recently as 1982, no foreign currency options were traded on an organized exchange and London- and United States-based banks were just beginning to experiment with the formation of an informal over-the-counter (OTC) foreign currency options market.[1] Recent studies estimate that United States and United Kingdom OTC markets account for approximately $10 billion each in outstanding foreign exchange

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[1] The first opportunity to trade currency options on an organized exchange became available when sterling options commenced trading on the Philadelphia Stock Exchange in December, 1982. The OTC foreign currency options market began developing in London in the late 70s, but there was little significant OTC activity in the United States until the 1982–83 period.

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options, with foreign currency exchange-traded and OTC options being issued in the United States alone at the rate of $20–30 billion per month.[2] The rise of a similar OTC market in Japan began a little later, but the growth of this market has been similarly dramatic, and legislation pending in the Diet is expected to provide for a new organized financial futures exchange which will ultimately include trading in foreign exchange options.[3]

The rapid emergence and dramatic growth of these foreign exchange options markets have raised a variety of significant legal and regulatory issues which are not yet fully resolved but which deserve, in light of the enormous amounts of money involved and the unparalleled volatility of the foreign exchange markets over the last decade, serious consideration by market participants, regulators and lawmakers alike before rather than after a market crisis compels such consideration in an atmosphere poorly suited to reflective decision making. The paper represents an effort to identify and analyze the most significant and substantial of these unresolved issues and to postulate lines of resolution for further consideration. To the extent practicable, the effort is made to compare the development of these issues in the United Kingdom and Japan with that under United States laws since the markets are so tightly interlinked as to constitute functionally a single market and because it is the laws of these three nations that are most likely to apply to disputes or breakdowns occurring in the three principal financial centers of London, Tokyo and New York in which the vast bulk of relevant options transactions are occurring.

Accordingly, section II of this paper presents a descriptive overview of the foreign currency options markets as they have evolved to date. An appreciation of the operation of these markets and of both their risk reduction functions and their risk creation potential is important in the consideration of an appropriate policy of regulatory response and in addressing the important contractual issues that remain outstanding. Section III addresses the substantial regulatory issues that have arisen in connection with foreign currency options traded mainly in the United States. As will be seen, the issues are primarily statutory and jurisdictional and are not yet fully resolved. Analogous issues under United Kingdom and Japanese law have proved to be more tractable, at least to date. In section IV, two interrelated contractual enforcement issues are addressed. The first involves the extent to which the "commodity theory of money"—the idea that a foreign exchange contract involves the purchase and sale of goods and nothing more-

[2] Fallon, *The Tilted Playing Field*, Intermarket 35 (June 1986); *Recent Innovations in International Banking*, Bank for International Settlements 72 (April 1986). These studies are supported by a Bank of England estimate that international commercial banks account for approximately $20 billion of outstanding currency options, averaging $2 to $3 million per transaction. *Currency Options: Choices, Choices*, The Economist 86 (May 4, 1985).

[3] *See infra* notes 111–114 and accompanying text.

—can impact on the law of remedies applicable to breach by the writer of an option, and in particular how this idea can incorrectly implicate the defense of impossibility. The second relates to the impact of this theory on the currency of damages for breach; the "home currency rule" and the difficulties it has caused are explored, and a variety of alternatives are outlined and examined. Section V presents an evaluation and proposes some conclusions and suggestions with respect to the evolving status of foreign currency options.

II. Overview of Foreign Currency Option Markets

A. Nature, Function and Uses

A foreign currency option (FCO) is a contract which gives to the purchaser ("holder") the right, but not the obligation, to buy (or sell) a specified quantity of a particular currency at a fixed price (the "strike price") on or prior to a specified future date (the "expiration date") from (or to) the seller or grantor of the option (the "writer"). The purchase price paid by the holder to obtain this right against the writer is the "premium."[4]

An option under which the holder has the right to buy the underlying currency from the writer is referred to as a "call," while one that gives the holder the right to sell the underlying currency to the writer is referred to as a "put." An FCO which may be exercised by the holder and settled at the strike price at any point up to or on the expiration date is an "American" or "American-style" option; a "European" option may be exercised only on its expiration date, and thus is usually less valuable and commands a lower premium than an American option. When the market or "spot" price of the underlying currency is below the option's strike price, a call is said to be "out of the money," while a put is described as "in the money." Conversely, when the spot price is above the strike price, a call is "in the money" and a put "out of the money."[5]

Foreign currency options are traded both on organized exchanges and in the over-the-counter market. Most FCOs, like most foreign exchange futures or forward con-

[4] Material in this part draws on J. Cox & M. Rubenstein, Options Markets (1985); M. Fitzgerald, Financial Options (1987); J. Heywood, Using the Futures, Forwards and Options Markets (1984); H. Riehl & R. Rodriguez, Foreign Exchange and Money Markets: Managing Foreign and Domestic Currency Operations (2d ed. 1983); J. Walmsley, The Foreign Exchange Handbook: A User's Guide (1983); J. Grabbe, International Financial Markets (ch. 6, Foreign Currency Options) (1986); T. Andersen, Currency and Interest Rate Hedging 105–190 (Options) (1987); S. Bronte, Japanese Finance: Markets and Institutions (1982); Bartlett & Ludman, Over-the-Counter Foreign Currency Options (Dec. 1986); Committee on Commodities Regulation, Association of the Bar of the City of New York, The Evolving Regulatory Framework for Foreign Currency Trading (June 1986); Gilberg, *Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws*, 39 Vand. L. Rev. 1599 (1986).

[5] *See generally Foreign Exchange Options*, Federal Reserve Bank of St. Louis 12–13 (March 1984); Giddy, *Foreign Exchange options*, 3 J. of Futures Markets 143–66 (1983); Goodman, *How to Trade Currency Options*, Euromoney 73–74 (Jan. 1983).

tracts, involve the purchase or sale of a foreign currency against the United States dollar.[6]

Like forwards and futures, foreign currency options can serve the economic hedging function of transferring the risk of an unfavorable shift in the exchange rate from the holder to the writer (since it is the writer who assumes the obligation to sell the specified currency to, or to buy it from, the holder at a contractually-specified rate). Thus the holder can "lock in" or insure a specific rate of exchange for a currency it may be obligated to buy or sell in the future and so transfer to the writer the risk that the underlying currency will rise or fall in price.

The writer attempts to offset the assumed risk through appropriate pricing of the premium and by employing a variety of hedging strategies. Due to the high incidence of pricing flaws and the imperfections of available hedging techniques, however, the high risks of foreign exchange option writing have recently received increasing attention.[7]

FCO writers generally price their premiums based on any of several related computer pricing models deriving from the famous Black-Scholes model.[8] The economics literature of option pricing is large and growing, and this is not the appropriate place to review it.[9] For present purposes, it is sufficient to note that the models base their calculations primarily on five factors: the value of the underlying currency, the strike price, the remaining time to expiration, the differential interest rate expected to apply over the life of the option, and the anticipated future volatility of the underlying currency. The first four factors are readily observable or estimated, but the fifth is not, and unfortunately is usually the most heavily weighted of the factors.

Volatility, which measures risk or price variability, is "the annualized standard deviation of daily percent changes in rates."[10] The foreign exchange markets have been extraordinarily volatile in recent years. It is no longer unusual for daily currency ex-

[6] *See id. See also* J. Walmsley, *supra* note 4, at 202.

[7] On pricing flaws, *see* the following paragraph in text. On hedging imperfections, *see infra* notes 39–46 and accompanying text. After the collapse of the Herstatt Bank in 1974, major central bank governors set up a committee of supervisors, the so-called Basle Committee, which normally meets three times a year at the Bank for International Settlements. *See* Walmsley, *supra* note 4, at 14. Working through these channels, central banks have been evolving a series of capital adequacy standards parts of which address controlling foreign exchange contract risks. *See, e.g.*, Agreed Proposal of the United States Federal Banking Supervisory Authorities and The Bank of England on Primary Capital and Capital Adequacy Assessment, Jan. 8, 1987, reproduced at CCH Fed. Banking Law Rep. ¶ 5402 (emphasizing determination to introduce capital requirement for exchange rate risk). *See also* Federal Reserve Board proposal to incorporate credit risks on foreign currency transactions, *infra* note 198.

[8] Black & Scholes, *The Pricing of Options and Corporate Liabilities*, J. of Political Economy, May-June 1973, at 637–54.

[9] Full discussion and analysis may be found in J. Cox & M. Rubenstein, *supra* note 4; M. Rubenstein, *A Survey of Option Pricing Models*, in M. Brenner (ed.), Option Pricing (1983); R. Bookstaber & R. Clarke, Option Strategies for Institutional Investment Management (1983). *See also* M. Fitzgerald, *supra* note 4, ch. 3–5 and extensive bibliography on options at 256–60; J. Grabbe, *supra* note 4, at 113–50.

[10] Kalberer & Wurman, *Volatility Varies Widely for New Currency Options*, Futures 84 (March 1985).

change rates to fluctuate by as much as 5%.[11] During the 12 months from January 1985 to January 1986 the U.K. pound fell to $1.05 before rising back to nearly $1.50 in November. Implied volatility rose from 14% at the beginning of the period to as high as 22% and back to 12% in December 1985.[12] Similarly, the average weekly Deutschemark/U.S. dollar volatility over consecutive six-month periods between 1978 and 1983 was often 12 to 15 percent.[13]

Option pricing theory holds that the premium on an FCO will adequately "absorb" the anticipated future volatility of the currency during the interval between the writing and the exercise or expiration of the option. But estimating future volatilities has proved "an art rather than a science" since the dollar devaluations of 1971 and 1973 and in light of the unprecedented volatility that currency markets have consistently displayed.[14] Thus writing "naked," or unhedged, options in reliance on adequate premium pricing techniques to cover the exposure is generally viewed as highly risky, if not imprudent.

As will be seen below, the availability of hedges as protection for option writers is often as limited as the protection afforded by pricing strategy. Consequently, while the profits earned in option writing are frequently quite substantial, the downside risks are commensurate and have drawn increasing regulatory concern in recent years.

Like forward and futures contracts, options also provide an opportunity for speculation in addition to their risk shifting function. As in other markets, speculative participation enhances the liquidity of the options market, thus making it easier for hedgers to offset their cash market price risks. Speculative participation in these markets thus serves as a necessary and desirable adjunct to participation by parties who are seeking to protect themselves against business-related foreign currency exposure.[15]

There are a number of respects in which options are significantly different from the more traditional instruments used for hedging foreign exchange risks (that is, forwards

[11] Szala, *Trading Currency Changes in Options 'round the World*, Futures 63 (July 1985).

[12] M. Fitzgerald, *supra* note 4, at 151.

[13] O'Dea, *The Fight Over Currency Options*, Intermarket 14, 17 (Feb. 1985).

[14] O'Dea, *Fencing With the Grim Reaper*, Intermarket 4, 6 (June 1985); J. Walmsley, *supra* note 4, at 62; De Grauwe, The Long Swings in Real Exchange Rates, 6 Bank of Japan Monetary and Economic Studies 37, 37–41 (1988). The volatility estimate is the only non-directly observable variable in the Black-Scholes Model. Many different methods of estimating volatility and their relative merits are discussed in the literature. *See, e.g.*, M. Fitzgerald, *supra* note 4, at 46–50 (simplified overview); Parkinson, *The Random Walk Problem: Extreme Value Method for Estimating the Variance of the Rate of Return*, 53 J. of Business 61–65 (1980); Garman & Klass, *On the Estimation of Security Price Volatilities from Historical Data*, 53 J. of Business 67–78 (1980); J. Cox & M. Rubenstein, *supra* note 4, ch. 4 & 5; Beckers, *Standard Deviations Implied in Option Prices as Predictors of Future Stock Price Variability*, 5 J. of Banking and Finance 363–82 (1981).

[15] *See generally* Harrington, *The Manipulation of Commodity Futures Prices*, 55 St. John's L. Rev. 240, 242–47 and materials cited therein (on need for speculators). *Cf.* Kaldor, *Speculation and Economic Activity* in B. Gross & B. Yamey, The Economics of Futures Trading (1976); Note, *The Delivery Requirement: An Illusory Bar to Regulation of Manipulation in Commodity Exchanges*, 73 Yale L.J. 171 (1973).

and futures). All three share the common characteristic of protecting their holders against the risk of adverse price movements in the cash markets. But forwards and futures also eliminate the upside potential that might otherwise benefit the holders if currency rates move in their favor. Options do not eliminate this potential because their holders are not committed to either offsetting the transaction or completing it at the agreed exchange rate. For this distinguishing benefit, the holder pays a premium, which also represents the limit of his losses in the event of an unfavorable movement in exchange rates: if the option becomes unprofitable, he has no obligation to exercise it.[16] Further, the holder of an FCO, in contrast with the holder of an exchange-traded futures contract, cannot be required to deposit variation margin if the option declines in value. Finally, while the holder of a forward or futures contract is restricted to a single settlement date or period, the holder of an American option can exercise and thus require settlement at any time prior to expiration of the option.[17]

These distinguishing characteristics make FCOs more flexible instruments, in the view of many, than currency forwards or futures, and particularly appropriate when a company's foreign currency exposure is merely contingent (an open bid in a foreign currency is the usual example)[18] or where an unrealized gain based on exchange rate movement has occurred in connection with a firm's investment abroad and it is desired to lock in the gain.[19]

FCOs have some well-recognized disadvantages, however, for both holders and writers. The most obvious disadvantage for holders lies in the nonrefundable premium paid up-front,[20] ranging typically between 1.5 and 4 percent of the currency amount of

[16] *See, e.g., Tradeable Insurance*, Intermarket 25,34 (Nov. 1985) (nothing that "a drawback to forwards is that they also eliminate any upside potential that might accrue if exchange rates move in their favor ... [O]n the other hand, since there is no obligation to exercise [an option], it does not take away the upside potential, should it develop.")

[17] *See generally* authorities cited *supra* note 5.

[18] This type of example is common in the literature. *See, e.g*, M. Fitzgerald, *supra* note 4, at 159; J. Heywood, *supra* note 4, at § 6.2. Thus, a company's foreign currency exposure is merely contingent where it tenders on an export order, bids to acquire a foreign company or business, or bids or a foreign construction contract. While the bid is outstanding, the company is subject to the risk that the exchange rate will move against it before the bid is accepted, making the project unprofitable to complete at the offered terms. In the past such risks were hedged in the forward market leaving the holder obligated to buy or sell the currency even if the market moved in its favor or the company did not win the bid. By using options, if the bid is not accepted, the company can let the option lapse unexercised, its out-of-pocket cost being the premium. If the option has moved "in-the-money," the company will exercise and sell the currency spot for the profit. Finally, the nature of the up-front premium payment facilitates quoting it into the bid itself. *See Tradeable Insurance*, Intermarket 25, 35 (Nov. 1985).

[19] *Recent Innovations in International Banking*, *supra* note 2, at 65.

[20] *See* Financial Times, Oct. 2, 1984, at 13; J. Andersen, *supra* note 4, at 207.

the option agreement (although premiums can and do go higher).[21] Some corporations are deterred from using options by both their expense and this cash flow disadvantage, particularly where it is felt that the currency exposure can be hedged through forwards (typically involving no cash outlay until settlement and where there is no "premium" but rather a commission buried in the interest differential).[22] The principal disadvantage for option writers lies in the asymmetrical nature of the instrument: unlike a holder, a writer can never gain more than the premium, but there is theoretically no lower boundary to how much it can lose.[23] Worse, while this risk can often be reduced by taking a position in the forward, futures or options markets, the exposure can just as often prove difficult to hedge due to high transaction costs, relative illiquidity, high volatility of currencies and the imperfections associated with "artificial" hedges such as "delta hedging" and its variations.[24]

B. Exchange-Traded Options

Options on foreign currencies are traded on eleven exchanges around the world as of December, 1987,[25] most notably (in terms of volume) the Philadelphia Stock Exchange (PHLX), the Chicago Board Options Exchange (CBOE), and the London International Financial Futures Exchange (LIFFE), while options on a variety of foreign currency futures contracts trade on the Chicago Mercantile Exchange (CME) and the Sydney Futures Exchange. Legislation introduced in the Japanese Diet in spring, 1988 is expected to authorize exchange trading of both currencies and currency futures on a new

[21] *See id,;Currency Options Help Manage Foreign Currency Savings*, 103 Global Trade Executive, No. 4, 21 (Oct.1985). The currency amount is calculated based on the spot rate, Andersen, *id.*

[22] *See*, O'Dea, *supra* note 14, at 10 (one trader complaining that when corporate treasurers "pay one-eighth of one percent a year for revolving credit lines, the reaction to paying four percent for ninety days' protection is that you're crazy.") On quotations, *see* Grabbe, *supra* note 4, at 77–78.

[23] The point is made throughout the literature. *E.g.*, J. Heywood, *supra* note 4, at 70; M. Fitzgerald, *supra* note 4, at 7; Goodman, *supra* note 5, at 74 (noting that a writer "can never gain more than the premium charged; at best he will lose nothing and retain the premium. But there is no limit to how much he may lose.")

[24] *See infra* notes 39–46 and accompanying text. *See also* Heywood, *When Options Are Better Than Forwards*, Euromoney, May 1984, at 214; Henley, *Why You Should Hedge Currencies With Options*, Futures, May 1984, at 72–74; *A Hot Insurance Policy on the Foreign Exchange Market*, Business Week, May 7, 1984, at 124; Agmon & Eldor, *Currency Options Cope with Uncertainty*, Euromoney, May 1983, at 227–28; *A Safer Hedge in Currencies*, Business Week, Jan. 17, 1983, at 102.

[25] These include the London Stock Exchange, European Options Exchange (Amsterdam), London International Financial Futures Exchange, the International Monetary Market (a unit of the Chicago Mercantile Exchange), Philadelphia Stock Exchange, Montreal Exchange, Vancouver Stock Exchange, Chicago Board Options Exchange, Hong Kong Exchange, Singapore International Monetary Exchange, New York Cotton Exchange (options on a dollar index).

financial futures exchange to be formed in 1988.[26]

There are some significant differences between exchange-traded FCOs and the options offered in the OTC markets by banks and institutional dealers. Thus, FCO positions on an exchange can be (relatively) readily liquidated because the presence of speculators tends to enhance liquidity and because of the standardization of contract terms on exchanges. Companies holding OTC options, however, may only sell those options back to the bank that wrote them, if they are able to liquidate them at all; anti-assignment provisions are virtually universal.[27] (Such standardization can cut the other way, since it effectively precludes a "perfect" hedge with respect to overall exposure; OTC options, on the other hand, can be precisely tailored to fit a firm's needs). Second, premiums on exchange-traded options tend to be lower than those in the OTC markets. Third, some customers claim they can obtain better executions in the OTC markets, especially for larger orders. Finally, the settlement process on exchanges is (generally) simpler, more standardized and less risky from a credit point of view.[28]

While banks continue to dominate the exchange-traded FCO markets, which enable them to hedge part of their OTC risk at lower premiums than would otherwise be the case,[29] the exchanges have also attracted both large multinational corporate users as well as a variety of smaller business users which do not wish to deal in the one-million-dollar-minimum-contract size that banks tend to insist upon in the OTC market.[30]

[26] Bill to Revise Securities and Exchange Law Concerning Securities Futures (Nikkei Financial, March 3, 1988 at 3, trans. Newsscan Finance, Tokyo); Ministry of Finance, Necessary Measures on Financial Futures and Options Transactions in Japan (provisional translation, Jan. 1988); *Japan Joins the International Fray*, The Banker at 39 (Feb. 1988); *Ministry Backs Bank Trading in Foreign Bond Futures*, Japan Economic Journal, March 12, 1988 at 12; *Bills Contain Regulations to Harness Insider Trading*, Japan Economic Journal, March 26, 1988 at 3; *Finance Ministry Brokers Futures Market*, Tokyo Business Today, March 1988.

[27] *Cf.* O'Dea, *The Fight Over Currency Options*, Intermarket, Feb. 1984, at 14, 18.

[28] The settlement process with banks in the OTC market varies among banks and even from deal to deal, and may be contrasted, for example, with settlement of options on PHLX and CBOE, which clear through the Options Clearing Corporation, which is owned by the five major U.S. exchanges which deal in options and is subject to SEC regulation. OCC is substituted as a principal with all buyers and sellers of FCOs and then is legally responsible both for delivery on the option to the buyer and for payment of the premium to the seller. It imposes membership standards (including balance sheet requirements), margin requirements and participation in a large guaranty clearing fund on all exchange members. *See* Knight, *The Unusual Guarantee Behind Option Trading*, Euromoney Supplement, at 42–44 (Feb. 1985). On the functioning of U.S. commodity exchange clearing house systems generally, see T. Russo, Regulation of the Commodities, Futures and Options Markets §§ 2.01–2.12 (1987); Brinkman, *The Role and Operation of Clearing Houses* in N. Rothstein & J. Little, The Handbook of Financial Futures (1984).

[29] *See Recent Innovations in International Banking*, *supra* note 2, at 72; *Tradeable Insurance*, *supra* note 18, at 30. Nevertheless, there is evidence that exchange traded FCOs are often overvalued. *See*, *e.g.*, Goodman, Ross & Schmidt, *Are Foreign Currency Options Overvalued?*, 5 J. of Futures Markets 349 (1985).

[30] *See* Sender, *New Era in Foreign Currency Trading*, Dun's Business Month 71 (Sept. 1984); *Tradeable Insurance*, *id*,; *Bacardi Capital Ltd. Acquires Majority of FOB Groups*, PR Newswire, Sept. 9, 1985.

C. The Over-The-Counter Options Market

The OTC options market in foreign currency began developing in London in the late 70s, but little significant activity occurred until 1983, after the PHLX commenced trading in FCOs. Today it is generally agreed that the OTC market is substantially larger than the exchange-traded markets.[31] Recent studies put trading in the New York OTC market at $110 million a day, and in London at about 50% higher volume[32] and estimate the U.S. and U.K. market at roughly $10 billion each in outstanding amounts.[33]

The Tokyo OTC market commenced in 1984 and achieved real depth beginning in late 1985 with the substantial increase in dollar-yen volatility engendered by the "Plaza Agreement." Dealers estimate that the total outstanding stock of FCOs in the Tokyo market in early 1988 has multiplied by several times the estimated outstandings of a year earlier. About 70% of FCOs in the Tokyo market are written with maturities of 3–6 months; forward transactions in the market typically mature in 1–4 weeks. Most FCO transactions in Tokyo (approximately two-thirds) are executed to accommodate customers and the associated risks are hedged by the writers. About 90% of these options are between the yen and the dollar, and approximately 70% are European-style options (which of course are easier to value, easier to hedge and cheaper as to premium).[34] Most of the customer-related options business generated in the Tokyo market is attributable to the marketing of "zero cost options," a term which encompasses a variety of related option "combination" strategies, the most basic of which entails the customer's purchase of a put while writing an equal but opposite call (or vice versa) (balancing the premium paid for the put against that received for the call) in the same currency and at the same maturity.

Most over-the-counter FCOs are written by the major industrial commercial and investment banks, attracted to the business both by the substantial fee income and by customer demand.[35] Buyers of these options are primarily larger corporations active in international trade and financial institutions with multicurrency asset portfolios; recent estimates were that fewer than 100 major United States corporations were using OTC currency options, with $10 to $20 million transactions becoming commonplace.[36] Mini-

[31] *See* Nicoll, *A Boon to the Corporate Treasurer*, Financial Times, Dec. 11, 1985, at 6; O'Dea, *supra* note 14, at 4.

[32] *Tradeable Insurance*, *supra* note 18, at 28; O'Dea, *Competing for Currency Options*, Euromoney 34 (Apr. 1985).

[33] *See Recent Innovations in International Banking*, *supra* note 2, at 72; *Currency Options: Choices, Choices*, The Economist 86 (May 4, 1985).

[34] On the operation of the Tokyo foreign exchange market generally, *see* Y. Suzuki (ed.), The Japanese Financial System 127–31 (1987).

[35] *See A Hot Insurance Policy on the Foreign Exchange Market*, Business Week, May 7, 1984, at 124.

[36] *See Tradeable Insurance*, *supra*, note 18, at 28; O'Dea, *Competing for Currency Options*, *supra* note 32, at 34; Fallon *supra* note 2, at 35.

mum denomination is typically $1 million with the typical outside maturity being one year (although longer maturities are not uncommon).[37] The attractions for these corporate holders include (1) the fact that OTC options can be tailored to meet the exact dimensions of the risks they want to hedge, (2) the convenience associated with not needing to devote their own resources to managing currency exposure, (3) a concern that larger orders might not be promptly filled or liquidated on exchanges and (4) the fact that options on more "exotic" currencies are available only in the OTC markets (at correspondingly higher premiums).[38]

Non-banking corporations thus are far more likely to buy FCOs than to write them; in fact it was recently estimated that the pool of option holders exceeds the pool of available option writers by at least three to one, and perhaps by as much as nine to one.[39] In light of this imbalance, banks cannot normally just hedge the options they write with other FCO options; instead they must find other ways to lay off or at least ameliorate the risks they assume, including one or more of the following efforts. First, banks often lay off their risks through an informal interbank FCO market. This market is not very efficient, however, resulting in effect in interbank "swapping" of options and only imperfect risk hedging.[40] Second, this gap has given birth to a variety of money brokerage firms which have moved into this area to provide market information and traditional brokerage, encourage some standardization of terms and prices, and even act as principal or "go-between" for banks seeking to lay off risks.[41] Third, there has been significant movement toward standardization in the OTC markets. Thus, a committee of the British Bankers Association has standardized OTC option terms and procedures in cooperation with the London Interbank Currency Options Market (LICOM), a group of market participants,[42] to facilitate inter-institutional trading. Similarly, the New York-based

[37] *See, e.g.* J. Andersen, *supra* note 4, at 206.

[38] *See* Heywood, *When Options Are Better Than Futures*, Euromoney 214 (May 1984); Heberton, *When Buying OTC Is A Better Option*, Euromoney 85–87 (Nov. 1983).

[39] *See* O'Dea, *Fencing with the Grim Reaper*, Intermarket, June 1985 at 4, 10; *Tradeable Insurance*, Intermarket, Nov. 1985 at 25, 32; Mathias, *Standardize the Forex Option's Markets*, Euromoney, Dec. 1984 at 76; *A Hot Insurance Policy on the Foreign Exchange Market*, Business Week, May 7, 1984 at 124.

[40] *Cf.* O'Dea, *id.* at 10. It is understood that Japanese banks lay off their option exposure primarily in the United States interbank market in order to comply with administrative guidance from the Ministry of Finance that they maintain "level books" on foreign exchange options they have written. (March, 1988 interview in Tokyo by the writer with a knowledgeable market participant.) Effective March 22, 1988, the Ministry authorized 332 Japanese firms to engage in overseas option trading, but with trading in currency options restricted to foreign exchange banks. Japan Times, March 18, 1988 at 7.

[41] *See* O'Dea, *Competing for Currency Options*, Euromoney 34, 39 (April 1985). Three established money brokers commenced interbank options brokerage in 1984: Exco International and Bierbaum-Martin in London and New York, and Butler Treasury Securities in London.

[42] *See Recent Innovations in International Banking*, *supra* note 2, at 75–76; *Redundancy of the Crystal Ball*, The Bankers 60 (Aug. 1984); O'Dea *Fencing with the Grim Reaper*, Intermarket 4, 10 (June 1985).

Foreign Exchange Committee has been drafting similar terms for the same reasons[43] and the major Swiss banks have begun to trade standardized OTC options. Fourth, some banks lay off some of their OTC option exposure by setting up subsidiaries to trade listed FCOs on the exchanges. Thus BancAmerica Options has estimated that 80% of the Deutschemark options written by Bank of America's main office are hedged on PHLX.[44] Standardization and the small units of contract can make such hedging relatively difficult and inefficient. Fifth, writers of FCOs use a variety of "artificial" or "synthetic" (but highly sophisticated) option hedging techniques. The most common of these is "delta-neutral hedging." The technique is beyond the scope of this paper and involves generally buying or selling the underlying currency in amounts intended to neutralize the effects of small changes in the exchange rate on the value of the option.[45] Several other artificial hedging strategies have been adopted by writers in an effort to ameliorate the risks associated with their unbalanced books.[46]

D. New Products

During the past four years commercial and investment banks have begun to market a variety of new products based on or derived from foreign exchange options. Designed to enhance the strengths or overcome the weaknesses of managing exchange exposure through FCOs, these products are often little more than novel trading strategies using foreign exchange options in conjunction with other financial instruments with which they are "packaged." Six such new products are sketched here to illustrate the exotic and useful possibilities which creative use of FCOs can offer both issuers and investors.

[43] The writer has consulted in connection with this drafting effort.

[44] *See* Tradeable Insurance, Intermarket 34, 36 (Nove. 1985); Gordon, *The Options Increase for Philadelphia*, Euromoney 349 (Oct. 1984); *Hobson's Choice*, the Economist 65 (Aug. 18, 1984).

[45] *See generally* J. Cox & M. Rubenstein, Options Markets, *supra* note 4, at 289–307; *Recent Innovations in International Banking*, *supra* note 2, at 77–80; M. Fitzgerald, Financial Options, *supra* note 4, at 41–46, 165–79. The strategy is in essence a synthetic call option. In a famous article, Professors Hull and White of York University noted that because "a naked position works well [for a writer] if the FCO is not exercised and a covered position works well if it is exercised [because in either case the writer's full premium income is retained], ... some intermediate position is correct." They concluded that at the time a call option is written, the writer should buy spot an amount of the underlying currency equal to its "delta value" times the amount of the option. The "delta value" (or "hedge ratio") is how much the value of a currency option changes for each movement in the value of the underlying currency. Since the delta value for any option changes with time and spot rate movements, the writer must constantly adjust the amount of currency held to maintain the "hedge", arguably a costly inefficiency. Hull and White argue that "when this is done over the life of the FCO, the [writer] will always be protected against changes in the spot rate." Hull and White, *Currency Options and the Banks*, Canadian Banker 46–50 (Feb. 1985). See also J. Grabbe, *supra* note 4, at 140–46; J. Andersen, *supra* note 4, at 154–57.

[46] *See, e.g.*, Dillman & Harding, *Life After Delta: the Gamma Factor*, Philadelphia Stock Exchange (Euromoney Survey) at 14 (1985); *Recent Innovations in International Banking*, *supra* note 2, at 81–92.

1. Currency Warrants

Of the variety of warrant offerings in recent years, none was more innovative than General Electric Credit Corporation's registered (in the U.S.) public offering in 1987 of $100 million of three-year notes and 2 million detachable cash settlement five-year put warrants on the Japanese yen, underwritten by Bear, Stearns. The principle is that the warrants are exercisable at any time during their term and have a value linked to the spot price of the yen. At exercise or expiration, the holder will receive a payment in U.S. dollars to the extent that the yen has weakened below the strike price. They expire worthless if they are out of the money at expiration. They are listed and traded on the American Stock Exchange, leading the staff of the Securities and Exchange Commission (SEC) to conclude that they are "securities" subject to the exclusive jurisdiction of the SEC.[47]

The offering captured the imagination of Wall Street for a period, being hailed as "Deal of the Month" by the *Investment Dealers' Digest.* Five other foreign currency warrant offerings followed in short order, including one where warrants alone were sold, and 1988 has seen additional offerings. From the standpoint of issuers, the proceeds from the warrants reduced overall financing costs since the costs of the currency hedge were less than the warrant proceeds. From the standpoint of investors, the warrants permitted access to the long-term currency markets.[48]

Similar variations on the theme have been introduced by Japanese issuers and securities firms in recent years. Examples include Nomura's "Heaven and Hell" $100 million Eurobond issue for IBM Credit Corporation, chosen as "Deal of the Year" by *International Finance Review*, and designed (by a complex series of swaps) to yield high premiums if the dollar rose against the yen and to dilute principal if the yen appreciated; "dual currency bonds," constituting 48% of the Euroyen bond market in 1985; "reverse dual currency bonds" initiated in 1986 by Kawasaki Steel and purchased and redeemed in yen, but bearing interest paid in dollars; "sushi bonds," devised by Yamaichi Securities, consisting of non-yen-denominated bonds issued by Japanese institutions in the Euromarket; and "split dual currency issues" designed by Nomura at the end of 1986 so that holders receive on maturity a fixed percentage of the proceeds in yen and the balance in a

[47] *See* General Electric Credit Corporation Prospectus relating to $100,000,000 Notes Due 1990 and 2,000,000 Currency Exchange Warrants Expiring June 15, 1992, dated June 10, 1987; Letter dated April 21, 1987 of R. Ketchum, Director, Division of Market Regulation, Securities & Exchange Commission, relating to the above; Monroe, *Currency Warrants Get a Financing Role*, Wall St. J., July 24, 1987 at 22, col. 1.

[48] *See generally Betting That the Dollar Is Bound to Rebound*, Business Week, Jan. 18, 1988 at 77; *Currency Warrant Bonds Are Back, But For How Long?* Corporate Financing 21–22 (March 1988). The letter article notes interestingly that some issuers, such as GMAC, which have ready access to such financing but have refrained out of concern that the warrants contain such high risks of the investor that offering them might change the perception of the issuer by investors in the long term. With respect to legal issues raised by the transactions, *see infra* notes 95–96 and accompanying text.

non-yen currency, representing a currency speculation.[49] There have been intricate variations on these themes,[50] sometimes called "Currency Convertible Securities" (or CCSs), all typically debt investments with an FCO feature.[51] In light of the volatility of the dollar against most currencies, investors in CCSs may obtain more benefits from the protection and upside potential than they give up in accepting lower yields.[52]

2. Currency-Indexed Hybrids

In the past two years there has been a proliferation of securities products with returns linked wholly or in part to the price of a commodity, such as oil, precious metals or a foreign currency. Recent important examples of such currency-based instruments include the March 1987 offering by the Student Loan Marketing Association ("Sallie Mae") of $100 million of 12–1/8% Notes Due 1990, where the principal amount payable at maturity will be the then U.S. dollar equivalent of 1,452 Australian dollars per $1,000 face amount. Two months later, Sallie Mae offered $100 million of 10–7/8% Notes Due 1992, with principal payable at maturity to be equal to $2,000 minus the then U.S. dollar equivalent of 138,950 Japanese yen per $1,000 face amount.

3. Equity Warrants

Since 1982, many Japanese corporations have issued detachable foreign currency denominated equity warrants to enhance fixed interest rate bond offerings in the Euromarket; between 1982 and 1985, 132 Japanese companies raised more than $6 billion by issuing such bonds with attached warrants. Since 1986 Japanese investors have been permitted to purchase non-yen offshore-issued warrant bonds, with the consequence that warrants have the potential of becoming a viable means of raising capital in the Japanese domestic market.[53] The main attraction to Japanese companies of issuing equity-related bonds in Europe has been the low borrowing cost (in yen terms) that they provide; thus, in February 1988, the proceeds of an equity warrant bond could be swapped into yen to give a cost of borrowing of less than 2%.[54] Although issues of bonds bearing warrants to buy shares in Japanese companies have boomed in the Eurobond market in the past few years, the underlying shares have almost invariably been sold back into Japan.

4. Cross-Rate Options (CROs)

A CRO is an option on the exchange rate between two currencies, and is far more popular in Europe than elsewhere. They tend to be less volatile than standard FCOs, thus

[49] A. Viner, Inside Japanese Financial Markets 186–87 (1988).

[50] *Id.* at 188.

[51] *See* Biger & Hull, *The Valuation of Currency Options*, 12 Financial Management 24 (Spring 1983).

[52] In addition the reduction in yield on the CCSs may be less than the premium the investor would otherwise have to pay to hedge its exchange exposure in the OTC or exchange markets. *See* Mallozzi, *An Emerging Way to Cut Borrowing Costs*, Euromoney Supplement at 11 (Feb. 1985).

[53] A. Viner, *supra* note 49, at 80.

[54] Pearson, *Euromarket First for Katokichi*, Financial Times, Feb. 15, 1988 at 11.

"allowing traders to sleep better at night,"[55] and CROs therefore also tend to bear somewhat lower premiums. It has been reported that some major foreign exchange market participants would like to be able to write CROs on exchanges, and two years ago the European Options Exchange commenced a British pound/Dutch guilder CRO.[56] The CME, however, has refused to follow suit.[57]

5. *The Boston Option (BO)*

The BO is essentially two contracts, a forward purchase and the option to reverse that forward (i.e., a put). Effectively a synthetic option, it responds to be complaint that payment of an up-front premium for an option creates cash flow problems. The price of the BO is the forward rate plus a premium. The FCO strike price is the forward rate alone, so that if the currency weakens against the forward rate, the holder of a BO would exercise the FCO to sell the currency back to the writer, buying the currency at spot at a gain. The BO hedges a currency exposure while allowing unlimited gains from a favorable rate exchange. The limit on loss is the premium·of the BO over an ordinary forward.[58]

6. *Indospreads*

These so-called "fences," developed by Banque Indosuez in New York, balance the purchase of a put against the writing of a call so that the holder of an Indospread acquires the right to require the writer to purchase currency at an "out of the money" price; but the holder must also agree to deliver the currency when it moves "in the money." Premiums for Indospreads tend to be much lower than those for "straight" options.[59] A variation on this option "combination" theme is the "zero cost option" heavily marketed in the Tokyo market and alluded to above.

III. The Regulatory Issues

A. Overview

Against the backdrop of the market descriptions and analyses in section II, this section III addresses the primary regulatory issues which have arisen. The regulatory structures of United States, United Kingdom and Japanese law are presented, with particular and detailed attention given to the U.S. issues both because the writer is more comfortable with them and because both the U.K. and Japanese regulatory systems are

[55] O'Dea, *Fencing with the Grim Reaper*, Intermarket 4, 8 (June 1985).

[56] *See* O'Dea, *Competing for Currency Options*, Euromoney 34, 37 (April 1985); *Tradeable Insurance*, Intermarket 25, 39 (Nov. 1985).

[57] *Cf. The Fight Over Concerning Options*, Intermarket 14, 58 (Feb. 1985).

[58] The BO was created by the Bank of Boston. *See* Cicchetti, *The Beauty of the Boston Option*, Euromoney 45 (Feb. 1985); Morris, *New Twist in Foreign Exchange Trade: One Advantage of BO Is Fee Hidden in Quoted Forward Rate*, American Banker, Oct. 3, 1984 at 1.

[59] *See Tradeable Insurance*, Intermarket 25, 32 (Nov. 1985).

only beginning to evolve (the former under 1986 legislation which is only now being implemented as this is written, and the latter under a system which has sharply curtailed the use of FCOs until now and which is undergoing significant liberalization, expected to culminate with the passage of proposed new legislation). An evaluation is offered in section V.

B. United States

1. Commodity Exchange Act

Certain types of foreign currency options are clearly subject to the jurisdiction of the Commodity Futures Trading Commission (CFTC), a federal administrative agency established in 1974 to regulate trading in commodity futures and options. The jurisdictional basis of regulation stems from the amendment of the Commodity Exchange Act (CEA) in the same 1974 amendments which created the CFTC to expand the definition of a commodity under section 2(a)(1)(A) to include "all other goods and articles, ... and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in ..."[60] To ascertain the Act's coverage of currency trading, it must first be determined whether foreign currencies are "goods and articles" (which apparently are commodities irrespective of whether they are traded on an exchange) or "services, rights and interests" (which apparently are not commodities unless they are the subject of futures contracts traded on an exchange). Although the issue is not yet resolved, the "right or interest" reading appears the better one. To characterize foreign exchange as goods, at least for this purpose, strains the ordinary meaning of the language and the view, developed below in section IV, that a contract to pay foreign exchange is better analyzed as a monetary obligation or debt rather than as a contract to provide a commodity.[61] In addition, foreign exchange has no inherent value as a tangible good, but derives its value rather from the right of its holder to exchange it for goods. One lower court decision supports this interpretation, under which only those foreign currencies traded for future delivery on a board of trade are commodities within section

[60] Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93–463, § 201, 88 Stat. 1389 (1974), 7 U.S.C. § 2 (1986).

[61] The question whether foreign exchange is money or a commodity (goods) is a subject of much controversy. In the United States, many cases have held that foreign money is a commodity. *See, e.g, United Equities Co. v. First Nat'l City Bank*, 374 N.Y.S.2d 937 (Sup. Ct. N.Y. Co. 1975), *rev'd on other grounds*, 52 A.D.2d 154, 383 N.Y.S.2d 6, *aff'd*, 41 N.Y.2d 1030, 395 N.Y.S.2d 640, 363 N.E.2d 1385 (1977) (mem.).

But there are cases *contra*. *See, e.g., Matter of Lendle*, 250 N.Y. Supp. 502, 166 N.E. 182 (1929). *See generally* Corbin, Contracts § 480 (1950); F. Mann, The Legal Aspect of Money 183–93 (4th ed. 1982). Dr. Mann persuasively argues that the appropriate principle is that "where the payment of a sum of foreign money is promised, a monetary obligation exists, because the foreign money functions as money ... . Only where foreign money is the object of commercial intercourse it will (*sic*) ... be regarded as a commodity." Mann, *id.* at 190. *See generally* the discussion *infra* in section IV.

2(a)(1)(A).[62]

Against the backdrop of this broad definition of a commodity, Congress proceeded to vest in the CFTC plenary authority to regulate option transactions involving commodities. Thus section 4c(b) of the CEA provides that "no person shall offer to enter into, enter into or confirm the execution of any commodity regulated under this Act which is of the character of ... an option ... contrary to any rule, regulation or order of the [CFTC] prohibiting any such transaction or allowing such transactions under such terms and conditions as the [CFTC] shall prescribe."[63] The CFTC's jurisdiction was made "exclusive" in the case of "accounts, agreements (including any transaction which is of the character of ... an option ...) and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a [designated] contract market or any other board of trade, exchange or market."[64]

At the same time, at the urging of the Treasury Department, Congress added the so-called "Treasury Amendment" to the CEA to prevent the newly-formed CFTC from regulating the foreign currency markets and thus risking disruption of their smooth operation. The Treasury Amendment provides, in pertinent part, that "Nothing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency ... unless such transactions involve the sale thereof for future delivery conducted on a board of trade."[65] The plain meaning of the Amendment's language thus excludes from the CEA's coverage all transactions in foreign currency, without regard to their nature or the character of their participants, unless those transactions are futures contracts executed on an exchange. The legislative history, however, is not clear on this point and can be read either to support this categorical reading or to suggest instead that the intent was to exclude from CFTC jurisdiction only markets and transactions in which large financial institutions already subject to federal regulation were the sole participants.[66] As might be expected, the CFTC staff has been developing a position favoring the latter interpretation, suggesting that the availability of the exclusion hinges

[62] CFTC & State of Georgia v. Sterling Capital Co., [1982–82 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,169 at 24,783 n.15 (N.D. Ga. Feb. 20, 1981).

[63] 7 U.S.C. § 6c(b) (1986). This provision and CFTC Reg. 32.11 set forth the general prohibition of options transactions, which is subject to the "trade option" exemption in Reg. 32.4(a) and the "dealer option" exemption in CEA § 4c(d) and Reg. 32.14. As of early 1988, certain foreign exchange-traded options were excepted from the ban. 52 Fed. Reg. 28980 (Aug. 5, 1987). The CFTC permits certain exchange-traded options pursuant to part 34 of its Regulations. The CFTC has no jurisdiction over options on foreign currency traded on a national securities exchange. CEA § 4c(f).

[64] 7 U.S.C. § 6c(b) (1986).

[65] 7 U.S.C. § 2 (1986). *See generally* Mitchell, *The Treasury Amendment & Foreign Currency Forward Transactions*, 5 Commodities Law Letter 1 (1985); Lyon & Mitchell, *Foreign Currency Option Trading Off Exchanges*, National Law Journal, Jan. 13, 1986 at 15; Gilberg, *supra* note 4, at 1648–59.

[66] *See* S. Rep. No. 1131, 93d Cong., 2d Sess. 23, 49–50 (1974).

not only on whether deferred delivery transactions in foreign exchange are not effected on an exchange, but also on the sophistication of the participants and the regulatory oversight to which they and the market in which they trade are subject. Thus, the CFTC has expressed the view "that the Treasury Amendment cannot be read so as to place outside the Commission's jurisdiction the marketing to the general public of such off-exchange foreign currency transactions; instead the Amendment was meant to encompass only transactions among and between banks and other sophisticated informed institutions."[67] The CFTC maintains further that any off-exchange transaction involving members of the general public is "strictly outside" the scope of the Treasury Amendment and is subject to CFTC jurisdiction.[68]

The CFTC's position is inconsistent with the language and policy of the Amendment's adoption, and should not ultimately prevail for reasons summarized in the accompanying footnote.[69] Nevertheless, the facts that it is not intellectually insupportable and

[67] CFTC, Statutory Interpretation and Request for Comments Concerning the Scope of the Treasury Amendment, Oct. 11, 1985, 50 Fed. Reg. 42983, 42984 (Oct. 23, 1985).

[68] *Id.* at 42985. For similar expressions of the CFTC's view, see CFTC, Office of the General Counsel, Memorandum, SEC-CFTC Jurisdictional Dispute [1975–77 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,117 (CFTC, Dec. 2, 1975); CFTC Interpretative Letter No. 77–12, [1977–80 Decisions] Comm. Fut. L. Rep. (CCH) ¶ 20,467 (Aug. 17, 1977).

[69] First, the plain meaning of the language of the Treasury Amendment excludes the transactions specified from regulation under the CEA. Nothing in the language suggests that the exclusion is conditioned on the sophisticated or institutional or regulated nature of the parties. References in the legislative history to regulated banks and dealers and to sophisticated institutions may fairly be read as describing the OTC markets as they were then known. *See Aaron v. SEC*, 446 U.S. 680, 699–700 ("in the absence of a conflict between reasonably plain meaning and legislative history, the words of the statute must prevail.") Second, it is clear from the legislative history that the Senate Committee on Agriculture knew that foreign currency trading was conducted "generally ... between banks and other sophisticated institutional participants." S. Rep. No. 1311, *supra* note 66, at 23. The language suggests the clear understanding that *not every* participant was regulated or sophisticated (or both). Third, the CFTC has failed to address the issues of what "sophistication" is, who is to define it, and how market participants are to clearly identify it ahead of time. Fourth, the policy underlying the Amendment was to permit the OTC market to grow on its own free of CFTC regulation. The CFTC's narrow interpretation cuts across that policy by limiting the exclusion to only those types of participants who were such in 1974.

The Commission has also been forced by its narrow view of the Treasury Amendment to give a broad interpretation to the term "board of trade" as used therein to cover not only trading on organized, licensed exchanges, but also trading in all off-exchange transactions other than trading between banks and institutional participants. CFTC Interpretative Letter No. 77–12, *id.* But this interpretation is at odds with the statutory definition in section 2(a)(1)(A) ("any exchange ro association ... of persons who shall be engaged in the business of buying or selling any commodity or receiving the same for sale or on consignment"). It is also at odds with the legislative history, in which it is clear that the Treasury Department and the Senate Agriculture Committee intended the phrase to mean "organized futures exchange" in this context. *See* S. Rep. No. 1(3), 93d Cong., 2d Sess. at 23, 49–50 (1974). Finally, this reading frustrates the policy of jurisdictional removal underlying the Treasury Amendment; for if the phrase "board of trade" is read too broadly, the Amendment becomes meaningless, a superfluous exercise. *See* Mitchell, *supra* note 64, at 5.

that indeed it has received some analogous judicial support in the cases make it risky to rely solely on the Amendment in structuring transactions designed to fall outside the scope of the Act either in the futures area or, as will be discussed below, in the foreign currency options area.

2. *Option Ban and the Treasury Amendment*

During its first years of life, the CFTC introduced a series of regulations to govern the offer and sale of commodity options. But in 1978, in response to widespread fraud in connection with the sale in the United States of "London options," the CFTC prohibited most commodity option transactions by regulation.[70] Congress codified the ban later that year, but concurrently gave the CFTC the authority to adopt regulations exempting options involving a purchaser that is a "producer, processor, commercial user of, or merchant handling" the commodity involved.[71] This authority has been implemented in a CFTC regulation known as the "Trade Option Exemption."

More recently, pursuant to a Congressional directive in the Futures Trading Act of 1986, the CFTC has relaxed its general ban on options trading and now permits certain exchange-traded options pursuant to part 33 of its Regulations.[72]

It was during the period of the option ban that most of the difficulty arose regarding the CFTC's asserted jurisdiction over FCOs offered and sold other than on a U.S. securities exchange, notwithstanding the plain meaning of the Treasury Amendment language exempting from CFTC jurisdiction all foreign currency options which are not traded on a commodity exchange.

In 1981 the PHLX took the position that the Treasury Amendment prevented the CFTC from regulating options on foreign currencies that were traded on a securities exchange. The jurisdictional uncertainties created by the PHLX's application to the Securities and Exchange Commission ("SEC") to trade the options was ultimately settled in an amendment to the CEA in 1982 making clear that the SEC, not the CFTC, has jurisdiction over foreign currency options traded on a national securities exchange like PHLX.[73]

Several judicial decisions also addressed the scope of the Treasury Amendment in the options context during the period of the ban. In *CFTC v. American Board of Trade*[74] the ABT, which was not registered with or regulated by any governmental body and

[70] 17 C.F.R. § 32.11 (1986), pursuant to the authority of section 4c(b) of the CEA.

[71] 7 U.S.C. § 6c(c) (1986).

[72] Futures Trading Act of 1986, 102, 100 Stat. 3557, codified at 7 U.S.C. § 4c(c) and (d). *See also* authorities cited *supra* note 63. The 1986 amendments also authorized for the first time public trading of options on futures. Futures Trading Act of 1986, § 102, 100 Stat. 3557.

[73] 7 U.S.C. §§ 6c(c), 6c(f) (1986). On the history of this jurisdictional dispute, *see generally* 1 T. Russo, *supra* note 28, at §§ 10.22–10.26 (1987).

[74] 473 F. Supp. 1177 (S.D.N.Y. 1979), *aff'd*, 803 F.2d 1242 (2d Cir. 1986).

which nevertheless provided an "exchange" for certain commodity option transactions, argued that its FCO transactions involved "transactions in" foreign currency for purposes of the Treasury Amendment. The district court below held, in a rather literalistic *trompe-l'oeil*, that an FCO is a transaction *involving* foreign currency (and thus falls within the proscriptions of the option language of the Act and regulatory ban), rather than a transaction *in* foreign currency (in which case the exclusionary language of the Treasury Amendment would apply). Under this disturbingly wooden analysis, the holder does not engage in a "transaction in" currency until there is actual exercise of the FCO, an event which transmutes the transaction from one "involving" currency to one "in" currency. The decision was affirmed by the Court of Appeals for the Second Circuit on the basis of legislative history, which showed, in the court's view, that the primary rationale of the Amendment was that "the protections of the [CEA] were not needed for sophisticated financial institutions, already subject to regulation, that participated in such transactions," and that an appreciation of this purpose undercuts "the notion that the exception was designed to exclude from regulation foreign currency options transactions *such as those defendants engaged in with private individuals.*"[75] It is thus possible to read the affirmance narrowly as holding only that the Treasury Amendment does not exclude FCO transactions between individuals and unregulated entities like the ABT (although the decision on appeal does affirm and adopt the much broader opinion below).

The facile and attenuated distinction between "transactions in" and "transactions involving" was approved and adopted by another Federal District Court in a similar suit by the CFTC against a firm selling FCOs to the general public.[76] More significantly, it was adopted by the Seventh Circuit Court of Appeals, which held in *Board of Trade v. SEC*[77] that options on Government National Mortgage Association (GNMA) pass-through certificates were not excluded from CFTC jurisdiction by the Treasury Amendment because they "involved" GNMA futures then traded on a commodity exchange and because the options were not "transactions in" government securities (which the Treasury Amendment also excludes from the scope of the CEA). While the court expressly stated that its analysis was not necessarily applicable to foreign currency, a case which was not before it, the language and logic of the analysis would seem to be directly applicable.

It is possible to read these decisions narrowly. Each case involved sales of options to the general public rather than to sophisticated institutions, and the two options cases involved unregulated entities. The courts might have reached a different result had interbank and institutional dealers been involved in light of those parts of the legislative

[75] 803 F.2d 1242, 1249 (emphasis added).

[76] *CFTC v. Sterling Capital Co.*, [1980–82 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,169 (N.D. Ga. 1981).

[77] 667 F.2d 1137 (7th Cir. 1982).

history, noted above, which suggest this intention.[78]

The fact that the focus of the Treasury Department's efforts in obtaining the Amendment was on "futures trading" among banks and dealers without explicit reference to FCO dealing should not be troublesome in light of the fact that FCO markets did not develop in the U.S. until eight years later. And as has been seen above, FCO transactions serve the same economic functions and involve the same types of institutional participants as the OTC foreign currency forward market did in 1974. The rationale underlying the Treasury Amendment's adoption is thus equally applicable to FCO transactions occurring in the OTC markets, and thus it may be fairly reasoned that the latter transactions are exempt from any CFTC regulation.

Such a conclusion is seriously undercut, however, by the reasoning of the courts in the three cases discussed above, which suggest no exceptions for interbank or institutional OTC transactions. It is also eroded by both the CFTC's interpretation of the Treasury Amendment, outlined above, and the expansive view it has articulated regarding its authority over FCOs. Thus in a 1985 letter to the SEC, the CFTC claimed authority to regulate FCOs "when they are traded other than on a national securities exchange," further asserting jurisdiction over all FCOs except transactions "in an option on foreign currency traded on a national securities exchange."[79] Similarly, the staff of the CFTC suggested in a 1984 letter that FCOs traded on a non-U.S. exchange could be purchased by U.S. banks only pursuant to the Trade Option Exemption, without reference to the applicability of the Treasury Amendment.[80] It should be noted, however, that more recently the Federal Reserve Board staff has taken the position that the Treasury Amendment excludes from CFTC jurisdiction FCOs traded in the interbank OTC market between regulated financial entities and their "sophisticated" customers.[81]

It must therefore be recognized that, while substantial principled arguments support the conclusion that over-the-counter FCO transactions in the interbank and dealer markets are excluded from CFTC jurisdiction by the Treasury Amendment, the CFTC's view and relevant judicial analysis materially weaken this conclusion and leave the area a shambles of uncertainty. The judicial interpretations also leave ultimate resolution of the Treasury Amendment problem subject to the sterile and poorly-reasoned argument of implied Congressional adoption or ratification of the decisions based on the comprehen-

[78] *See supra* notes 66–69 and accompanying text. The cited portions of the legislative history contain references, e.g., to the OTC market's being "more properly supervised by the bank regulatory agencies," to transactions as being "generally ... between banks and other sophisticated institutional participants," to a "dealer market [consisting] primarily of the large banks," to participants as "sophisticated and informed institutions," and to CFTC's lack of expertise "to regulate a complex banking function."

[79] Letter dated Sept. 27, 1985 to J. Wheeler, SEC, from J. Webb, Secretary, CFTC (LEXIS).

[80] CFTC Interpretative Letter No. 84–7 (Feb. 22, 1984), 2 Comm. Fut. L. Rep. (CCH) ¶ 22,025.

[81] Letter dated March 6, 1986 to K. Raisler, General Counsel, CFTC, from M. Bradfield, General Counsel, Board of Governors of the Federal Reserve System (copy in the writer's files).

sive amendments to the Act which took place in 1982 and 1986 in connection with reauthorization of the CFTC.[82]

3. *The Trade Option Exemption*

In light of the uncertainty created by the CFTC's position and judicial decisions regarding whether the Treasury Amendment exempts from CFTC jurisdiction FCOs transacted in the OTC markets, use of the Trade Option Exemption remains an alternative, and perhaps more reliable, way in which to structure OTC option transactions to be free of CFTC regulation (other than its antifraud rules).[83] This exemption applies to options offered or sold by a person who "has a reasonable basis to believe" that "the purchaser is a producer, processor, commercial user of, or a merchant handling, the commodity involved in the transaction"[84] and that this purchaser "is offered or enters into the commodity option transaction solely for purposes relating to its business as such."[85] Only the purchaser, not the writer, must qualify as a commercial user. The "basis to believe" language appears only in the statute, not in the regulation.

The CFTC staff has expressed, predictably, a restrictive interpretation of the exemption. In a 1984 interpretative letter regarding the proposed offer and sale in the United States of FCOs traded on a foreign exchange, the Division of Trading and Markets stated that "banking institutions may qualify as purchasers of foreign currency options [under this exemption] only if those institutions (1) ordinarily are engaged in a direct, commercial use of the currency underlying the option purchased ... [and] (2) enter the transaction solely for non-speculative purposes related to their business as such." The letter stated that "option purchases that exceeded any bona fide hedging requirements would be speculative" and thus lose the benefit of the exemption, and that writers of options in reliance on the exemption "must take affirmative steps to insure" that the purchaser is

[82] Were this a convincing or cogent jurisprudential theory to begin with, it would be made even weightier by the Supreme Court's utilization of a similar rationale in recent decisions. *Merrill Lynch v. Curran*, 456 U.S. 353 (1982); *Herman & MacLean v. Huddleston*, 103 S. Ct. 683 (1983). It seems rather a stretch to attribute to Congress knowledge of these relatively few, obscure and semantic decisions. Quite apart from this, the "doctrine" has rarely been viewed as being particularly helpful, clear or authoritative. In short, it should be given no weight in this context. *See, e.g.*, Girouard v. United States, 328 U.S. 61, 69 (1946) (it is "at best treacherous to find in congressional silence alone the adoption of a controlling rule of law."); Helvering v. Hallock, 309 U.S. 106, 119–22 (1940); Toucey v. New York Life Ins. Co., 314 U.S. 118, 140–41 (1941). *See also* H. Hart & A. Sachs, The Legal Process: Basic Problems in the Making and Application of Law 1381–1404 (Tentative ed. 1958) (arguing that legislative reenactment justifies inference of adoption of prior construction only if "there is ground for concluding, independently of any false conception of legislative duty, that the legislature did know about the interpretation and did approve it," and that this will be rare absent evidence from the internal legislative history. *Id.* at 1404). *Cf.* Harrington, *Culpability and Its Content Under the Commodity Exchange Act*, 17 Conn. L. Rev. 1, 32–33 (1984).

[83] Trade options are subject to 17 C.F.R. §§ 32.8 (unlawful representations and 32.9 (antifraud rule).

[84] Commodity Exchange Act § 4c(c), 7 U.S.C. § 6(c)(c) (1986).

[85] 17 C.F.R. § 32.4(a) (1986). *See generally* T. Russo, *supra* note 28, at § 7.14.

qualified.[86]

The narrow interpretation of the exemption expressed in the letter is not warranted by either the CEA or the regulation. The statutory language refers to transactions in which "the purchaser is a producer, processor, commercial user of or a merchant handling, the commodity ..." The regulatory exemption requires only that the option be purchased "solely for purposes related to " the buyer's business as a commercial user of the underlying currency. Neither draws any hedging/speculation distinction.[87]

As is the case with the Treasury Amendment, the exact contours of the Trade Option Exemption remain unclear and the CFTC has offered interpretations which serve, without clear justification, to narrow its scope. The ambiguities created by these interpretations make reasoned business planning in the area difficult and risky and almost surely have a retardant effect on the growth of the FCO markets.

4. Federal Securities Laws

Pursuant to 1982 legislation, it is clear, if intellectually frustrating and incoherent, that the SEC, and not the CFTC, has exclusive jurisdiction over the trading of FCOs on a United States securities exchange, while the CFTC has such jurisdiction over all FCOs traded on U.S. commodity exchanges.[88] Although never formally resolved, a consensus among practitioners has evolved that the SEC has no jurisdiction over FCOs traded in the OTC markets.

The one zone of uncertainty regarding this last statement stems from a series of judicial decisions during the 1970s[89] in which the securities laws were found applicable to "naked" commodity option transactions (in which the writer does not own the underlying commodity or otherwise hedge its exposure, but rather uses the premiums paid by the

[86] CFTC Interpretive Letter No. 84–7, *supra* note 80.

[87] The letter also expressed the view that a U.S. party, including a bank, could not grant an option on foreign exchange because it would be unable to verify whether a particular buyer was qualified to use the Trade Option Exemption. More recently, the CFTC relaxed this position by order in respect of regulated U.S. banks, which may grant currency options on the Montreal Stock Exchange if they write the option as principal for business-related purposes without using customer funds and not as part of a scheme to offer or sell such options to third parties.

[88] *See* Pub. L. No. 97–303, 96 Stat. 1409 (1982), *codified at* 7 U.S.C. §§ 77(b)(1), 78c(a)(10), 78111(14), 78(i)(g), 80a–2(a)(3) and 80b–2(a)(18) (1982), and the Futures Trading Act of 1982, Pub. L. No. 97–444, § 102, 96 Stat. 2294 (1982), *codified at* 7 U.S.C. § 6c(f) (1982), respectively.
On the history of this jurisdictional compromise, sometimes referred to as the "Shad-Johnson Accord," *see* T. Hazen, Securities Regulation, § 19.6 (1985); 1 T. Russo, *supra* note 28, §§ 10.22–10.26.

[89] S.E.C. v. Commodity Options International, Inc., 553 F.2d 628 (9th Cir. 1978) (involving "naked double options" on futures); S.E.C. v. Norton, [1976 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,204 (N.D. Ill. 1976) ("naked" commodity options traded on a discretionary basis); In re Traders International, [1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,529 (N.D. Nev. 1974) (London options); Searsy v. Commercial Trading Co., 560 S.W.2d 637 (S. Ct. Tex. 1977) ("naked" commodity options). *See also* Jenson v. Continental Financial Corp., 404 F. Supp. 792 (D. Minn. 1975) (agreements to buy and sell silver coins and bars on margin with repurchase option at set price).

purchaser to speculate further in the markets). The rationale for such decisions was that the options constituted "investment contracts," and therefore were "securities"[90] in light of the Supreme Court's definition of an "investment contract" as "an investment of money in a common enterprise with profits to come solely from the efforts of others" in *SEC v. W.J. Howey Co.*[91]

Obviously all options involve an "investment of money" in the form of the premium. The courts alluded to reasoned further that the "efforts of others" test was satisfied because the extent of the investor's profits depended on the writer's success in speculating in the markets, while the "common enterprise" requirement was met where the purchasers' funds were "pooled" in such a way that "the success or failure of one investor's contracts and of the [writer's] contracts could have a direct impact on the profitability of another investor's contract."[92]

The majority of cases in which this issue has been raised, however, have concluded that the CEA removed jurisdiction over commodity options from the SEC and vested it in the CFTC.[93] Furthermore, most OTC currency options lack the "common enterprise" and "reliance" elements of the *Howey* definition because they are individually negotiated between writer and purchaser, with no expectation of profits to be derived for the holder's benefit from the writer's reinvestment of premium or from anything other than favorable market movements. Finally, many purchasers of OTC options are commercial users of the underlying currency, making it less likely, under the case law, that the related contract will be a "security."[94]

5. "Hybrids"

Based on the foregoing material, it becomes easy to appreciate the wide array of indexed investment vehicles newly available which share characteristics of a "security" as well as of futures or options.[95] For brevity's sake, the GECC yen options discussed above[96] provide a good example of the difficulties. Those currency warrants (and the two dozen or so offerings which have followed that offering well into 1988) are unique in that their legal status depends not on what they are, but on where they are traded. Had they

[90] The definition of a "security" in each of the Securities Act of 1933 and the Securities Exchange Act of 1934 includes an "investment contract." Securities Act of 1933, 15 U.S.C. § 78f *et seq.* (1986); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a *et seq.* (1986).

[91] 328 U.S. 293 (1946).

[92] S.E.C. v. Norton, [1976 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,204 at 21,126.

[93] Board of Trade v. S.E.C., 667 F.2d 1137 (7th Cir. 1982) (off-set options on GNMA pass-through certificates); S.E.C. v. Univest, Inc., 410 F. Clayton Brokerage Co. of St. Louis, Inc. v. Mouer, 531 S.W.2d 805 (S. Ct. Tex. 1975) (London options); International Trading Ltd. v. Bell, 556 S.W.2d 420 (S. Ct. Ark. 1977) (London options). See also S.E.C. v. American Commodity Exchange, 546 F.2d 1361 (10th Cir. 1976).

[94] *See, e.g., United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 858 (1975).

[95] A good, current overview of such "new wave instruments" may be found in Hiden & Crawshaw, *Indexed Off-Exchange Obligations*, 7 Commodities Law Letter 1 (1987).

[96] *See supra* notes 47–48 and accompanying text.

not been listed by the American Stock Exchange they would have been in breach of the CFTC's regulations on commodity options. In light of this, the related warrant agreements provide that the warrants will be deemed automatically exercised if they are delisted or a permanent suspension of trading occurs.

Similarly, a wide variety of securities with returns linked to the price of oil, precious metals or a foreign currency have been offered in the past two years, attracting regulatory attention and some litigation,[97] none of it conclusive.

In response to the myriad problems posed by such instruments, and in the wake of several seemingly inconsistent enforcement actions,[98] the CFTC recently approved for publication a notice of proposed rulemaking, prepared by a staff task force created to study off-exchange hybrid instrument problems, inviting comment on a proposed regulatory framework for dealing with some categories of off-exchange instruments.[99]

The Advance Notice of Proposed Rulemaking, a major first step toward explicit regulation of off-exchange products, suggests separate regulatory treatment for the following categories of off-exchange instruments:

1. Hybrid instruments that may possess incidental commodity futures or commodity option characteristics of such an insignificant or *de minimis* nature that they may be excluded from CFTC jurisdiction under the CEA; examples mentioned in the Release include annuities, pensions, and employment agreements in which amounts due are linked to an economic indicator or index.
2. Hybrid commodity option instruments that "are" within the CFTC's jurisdiction but because of the secondary and incidental nature of their commodity option components and the extent of their regulation by another agency, may warrant exemption, upon

[97] Recent examples include the following. Prospectus Supplement dated June 19, 1986 of The Standard Oil Company, involving detachable units of ten standard debt securities and two zero-coupon oil-indexed notes bearing a put feature exercisable twice a month in the year prior to maturity and entitling the holder to receive in cash the face amount plus a contingent amount equal to the price of oil at the time if that price exceeds $25 per barrel multiplied by a notional number of barrels os oil. In early 1988 several issuers offered long-term debt securities called "REALS" which pay interest at the greater of a fixed rate and the same rate plus changes in the Consumer Price Index for all Urban Consumers. A number of recent offerings have been indexed to various stock indices. The Chase Manhattan Bank has been offering stock-indexed CDs, and several banks have been offering gold-indexed CDs. Drexel Burnham Lambert and the American Stock Exchange have proposed a plan under which issuers would sell, on a registered basis, medium-term physical and cash settlement warrants on gold and listed for trading on the Amex's commodity exchange.

[98] One thinks, for example, of the CFTC's injunctive action against the Wells Fargo Bank's gold-indexed CDs; the CFTC subpoena against The Chase Manhattan Bank's oil swap program with producers and users which is similar to interest rate swaps except that oil prices, instead of an interest rate index, are used to measure payments by the floating rate payer; and the CFTC's refusal to say anything at all for the record regarding the Standard Oil offering referred to *supra* note 97. Many persons in the trade believe that category 3 in the Advance Notice discussed below is intended to prohibit the Chase program and programs like it.

[99] Advance Notice of Proposal Rulemaking Regarding Regulation of Hybrid and Related Instruments, 52 Feb. Reg. 47022 (Dec. 11, 1987).

conditions, from general compliance with CFTC regulations. This proposed exemption would permit such instruments to be traded off CFTC-designated exchanges based on a filing procedure that would, among other things, afford the CFTC notice of the proposed hybrid offering, establish the issuer's consent to submission to special calls for information from the CFTC, require disclosure to purchasers that the exempted transactions will not be regulated by the CFTC, and require representations by the issuer demonstrating satisfaction of the other conditions to exempt status. Those other conditions are quite onerous and include a minimum duration of three years, an independent annual return of at least 35%, and relation of the issuer's business to the commodity involved.

3. Certain commercial transactions that possess elements of forward contracts in conjunction with certain aspects of futures contracts, as to which prospective "no-action" treatment may be appropriate; these would apparently include swaps and forward rate agreements, and there would be a general requirement that the transactions be between commercial entities dealing in the commodity as principals.

4. Finally, off-exchange commodity transactions that do not fall clearly within the first three categories but which are potentially within CFTC jurisdiction would be addressed by the CFTC on a case-by-case basis.

It is noteworthy that the Advance Notice states that it does not address the scope or content of the Treasury Amendment.

C. United Kingdom

In a major shift from the British tradition of minimal regulation of exchange-traded and OTC options and futures, the new Financial Services Act 1986 ("FSA"),[100] which is being implemented at this writing (spring 1988), establishes a regulatory framework for a much broader range of investments than any single piece of U.S. legislation.

The FSA addresses both exchange-traded and off-exchange options and futures. Schedule 1 to the Act specifically includes options on currencies (as well as all futures, contracts for "differences"—i.e., cash-settled instruments—and options on gold and silver) as being "investments" for FSA purposes, which is the threshold question. Under the FSA, any person who deals in covered instruments (including currency futures and options) must be "authorized" by either the Securities and Investments Board ("SIB") or by being a member of a self-regulatory organization like the Association of Futures Brokers and Dealers ("AFBD") or The Securities Association ("TSA") and acting in

[100] Financial Services Act 1986, ch. 60. Major provisions of the Act came into effect April 29, 1988, the date it became a criminal offense to carry on investment business without authorization from one of a variety of appropriate regulators and the date on which a number of "conduct of business" rules became effective. It is reported that many of the authorizations were snarled in red tape. *See generally* Financial Times, April 29, 1988 at 1, col. 4 and at 14 (reviewing FSA history and pointing out variety of significant and basic legal issues that remain unresolved).

accordance with their respective rules. Engaging in an "investment business" without authorization is subject to criminal sanctions, and contracts entered into in violation of the FSA will not be enforceable. Both the AFBD and the TSA have promulgated extensive regulations for dealing in both on- and off-exchange products, including capital adequacy and risk disclosure requirements, segregation of customer funds and daily reporting requirements.

The FSA and the rules of the AFBD and TSA are geared forward a philosophy of investor protection and retail market, rather than wholesale market, protection. Consistent with British regulatory tradition, the Bank of England will continue (under the Banking Act 1987) to license and supervise banks and other deposit-taking institutions. More relevantly, section 43 of the FSA recognizes the Bank of England's central role in the wholesale money markets and exempts from the Act persons ("Listed Institutions") which are admitted to a list to be maintained by the Bank and which trade in large volume (as defined) in currency, gold and silver. Schedule 5 to the FSA sets forth the activities of Listed Institutions to which the exemption applies and includes dealing and arranging deals in and advising on gold, silver, currency and related futures and option investments.

The Bank of England's recent "Grey Paper,"[101] as well as an important speech by the Director of the Bank of England's Wholesale Markets Supervision Division,[102] describe the Bank's intentions with respect to the wholesale markets and make clear that it intends to regulate a wide range of financial instruments, including certificates of deposit and off-exchange options (including warrants) and forward contracts on currency, gold and silver, as well as interest rate options, forward rate agreements and repos. In a reversal of earlier practice, however, the Bank will not attempt to regulate transactions on recognized exchanges. Listed Institutions dealing in covered instruments in appropriate volume will be required to notify the Bank of their transactions and will be subject to capital adequacy requirements.

D. Japan

As suggested in section II, C. above, there is a flourishing institutional OTC market in FCOs in Tokyo.[103] With foreign banks handling a surprising 45% of currency trading,[104] it is likely that they handle a similar share of the options market.

The growth of these markets dates back to December 1980 when a major revision of

[101] Bank of England, The Regulation of the Wholesale Markets in Sterling, Foreign Exchange and Bullion (July 1987).

[102] Address by J. Townend, November 9, 1987, *Supervision of the Wholesale Money Markets*, British Bankers Association Conference on the Financial Services Act, *reprinted at* Bank of England Quarterly Bulletin (Feb. 1988). *See also* Bettelheim & Bushner, *Regulating Lookalikes*, International Financial Law Review 9 (Feb. 1988).

[103] *See generally* Y. Suzuki, *supra* note 34, at 127–31.

[104] *Look Who's Winning Tokyo's Currency Sweepstakes*, Business Week, April 11, 1988 at 37.

the Foreign Exchange and Foreign Trade Control Law was enacted, radically changing the general rule from one of prohibition of foreign exchange transactions by residents to one of (in principle) free foreign exchange transactions by residents.[105] Residents became allowed to hold foreign currency deposits and to borrow foreign currency from banks. Ceilings on the overall foreign exchange exposure of authorized foreign exchange banks remained in effect (and still do), as did the "actual demand" rule, which (until its abolition in 1984) restricted forward foreign exchange contracts to bona fide hedging of commercial transactions.[106]

The writing and trading of FCOs in the Tokyo market is largely a grey area legally, but a few propositions appear clear. First, under current interpretations of Article 65 of the Securities and Exchange Law (the Japanese counterpart of the U.S. Glass-Steagall Act), domestic and foreign securities companies are not permitted to make trading markets in foreign exchange or in FCOs.[107] This is consistent with the prohibition of the Foreign Exchange and Foreign Trade Control Law against virtually all direct transactions in foreign exchange between individuals and enterprises: almost all foreign exchange transactions must be carried out by authorized foreign exchange banks. It is understood, however, that this prohibition may be circumvented, as a practical matter, by either referring the transaction to a foreign-based affiliate or by referring it to a Japanese foreign exchange bank (in exchange for a part of the commission or spread). Second, trading in overseas options on currencies (as well as other options) has been illegal until March 22, 1988, when the Ministry of Finance allowed 332 Japanese companies to engage in overseas options trading; trading in overseas currency options will be allowed only to foreign exchange banks.[108] Third, writing and trading in domestic FCOs are illegal except for foreign exchange banks under interpretations of the Foreign Exchange and Foreign Trade Control Law. (Unlike the case of the United States, it is clear under Japanese law that neither foreign exchange nor contracts on it, such as options, forwards or futures, may be deemed "securities" for purposes of the Securities and Exchange Law).[109] Fourth, administrative guidance from the Ministry of Finance requires that domestic banks restrict their foreign exchange exposure within specified ceilings, and that the

[105] *See, e.g.*, Y. Suzuki, *supra* note 34, at 128–29; S. Bronte, Japanese Finance: Markets and Institutions 226 (1982); M. Fukao, *Balance of Payments Imbalances and Long Term Capital Movements*, Appendix C (Regulations on Foreign Investment by Japanese Institutional Investors), prepared for Fourth EPA International Symposium on Global and Domestic Policy Implications of Correcting External Imbalances, March 15–17, 1988; The Bank of Japan, Manual of Foreign Exchange Control in Japan 4 (1987); J. Horne, Japan's Financial Markets 142–72 (1985) (analyzing 1980 legislation).

[106] *Id. See also* Awamura, *Internationalization of the Yen, Part I*, at 9–14 vol. 22, Japan's Financial Markets, Foundation for Advanced Information and Research (1988).

[107] *See* Suzuki, *supra* note 34, at 15, 127.

[108] Japan Times, March 18, 1988 at 9.

[109] Securities and Exchange Law Art. 2(1).

balance of their exposure, including that on FCOs, be "square"—that is, hedged either in the spot or forward markets or by a back-to-back option. This "square book" rule has sharply retarded, in the view of some knowledgeable participants, the growth of the market; since banks cannot make significant profits by speculating themselves, they have little interest in doing the business or in making a market. Delta-neutral hedging, discussed above, is viewed as an appropriate hedge for purposes of the square book rule, but is not practiced by all banks. Most of the foreign exchange banks tend to lay off their risks for these purposes in the New York or London interbank OTC markets. Fifth, a small but growing secondary trading market in FCOs is developing in the Tokyo interbank market, in which FCOs are being quoted and sold based on their respective volatilities.[110]

Pursuant to the recommendations of a November 1987 study by a distinguished panel of advisers,[111] the Government introduced in the Diet in March 1988 legislation to amend the Securities and Exchange Law to authorize trading in stock index futures and foreign government bond futures and (in a separate Financial Futures Trading Bill) to authorize the establishment of a new financial futures exchange, under the auspices of the banking industry, on which trading in foreign currency futures and options is expected to be adopted.[112] The legislation contemplates that there will be a clearing house system on the new exchange, probably with the exchange itself acting as clearing house and assuming liability on all contracts up to settlement date.[113] Off-exchange trading of exchange-traded instruments (or of instruments based thereon) is to be prohibited, but this prohibition is drafted with the intention of not interfering with the existence or growth of existing OTC markets, including the OTC foreign exchange forward and options markets.[114] The market will be subject to Ministry of Finance regulation and administrative guidance, and is expected to promulgate specific regulations itself and to function generally as a self-regulatory organization. Further details are not available as of the writing.

IV. Remedies for Writer's Breach of the Foreign Exchange Option Contract

A. Overview

The purpose of this section IV is the limited one of investigating two aspects of the

[110] The statements labelled first, third, fourth and fifth are based on interviews by the writer in Tokyo in Spring, 1988 with persons deemed reliable and knowledgeable. The statements labelled third and fourth were corroborated by more than one such interview.

[111] The Financial System Research Council and The Committee on Foreign Exchange and Other Transactions, *On the Orderly Adjustment of Trading in Financial Futures and Options* (Nov. 26, 1987) (copy in the writer's files). *See also* Ministry of Finance, *Necessary Measures on Financial Futures and Options Transactions in Japan* (provisional translation) (Jan. 1988) (copy in the writer's files) (outlining Ministry's intentions).

[112] *See supra* note 26.

[113] Interview, Tokyo, April, 1988 with a person deemed reliable and knowledgeable.

[114] *Id.*

law of remedies for breach of contract in the context of foreign exchange options. The first is to focus on the implications of the so-called commodity theory of money on the availability of remedies to the holder of a foreign currency option whose writer has defaulted under U.S., U.K. and Japanese law; the principal suggestion is that treating money as "goods" can have severe, unexpected and unwarranted implications in the area of the defense of impossibility. The second is to examine the rather chaotic effects which the "home currency rule" of damages can have on the law of remedies for breach of contract in the FCO context, to explore and evaluate some of the newer solutions that have been proposed, and to suggest the direction in which the law of remedies should be moving in this area as a reflection of sensible policy choice.

B. Remedies and the Commodity Theory of Money

1. *Applicability of General Contract Law*

It is useful to begin with a statement of the obvious: that a breach by the writer of an option either before exercise by the holder[115] or afterward (i.e., normally, a failure to deliver the currency) involves basic contract law of remedies. It is true that it may involve much more, as will be seen below. But despite the complexities introduced by the paucity of decided cases and the niceties of such doctrines as *force majeure*, the "home currency" rule and the "breach date" rule, it is important to bear in mind that basically one is dealing with breach of contract by a seller and that the guiding principles involved are fairly well developed in the jurisprudence: notions such as, for example, that the policy goal is to compensate the injured party for losses it has actually sustained from the breach;[116] that remedies such as rescission or specific performance are not favored;[117] and that at some point, intervening illegality or impossibility might operate to excuse performance by the defaulting party.[118]

[115] Such a breach could take the form, for example, of an anticipatory repudiation, a failure to give reasonable assurances when reasonably requested, breach of a financial covenant or a filing in bankruptcy.

[116] *See, e.g.*, F. Mann, *supra* note 61, at 123–31, 312; Uniform Commercial Code § 2–713 and comment 1 (Official Text 1978) (sometimes referred to hereinafter as UCC); J. White and R. Summers, Uniform Commercial Code §§ 6–4 and 10–3, 10–4 (2d ed. 1980) (hereinafter cited as White & Summers); Brand, *Restructuring the U.S. Approach to Judgments on Foreign Currency Liabilities*, 11 Yale J. of Int'l Law 139, 177–81 (1985). Or, to put the policy goal in the words of the Restatement of Contracts, to place the non-breaching party in "as good a position as he would have been in had the contract been performed." Restatement (Second) of Contracts § 344(s), comment a (1981). *See also* C. McCormick, Handbook on the Law of Damages § 49 (1983); 5 S. Williston, Contracts § 1338 (rev. ed. 1937).

[117] *See, e.g.*, Uniform Commercial Code *id.*, § 2–716; White & Summers, *id.*, § 6–6; F. Mann, *id.*, at 113–14. Specific performance is a favored, rather than a disfavored, remedy in Continental systems of law. A. Nussbaum, Money in the Law-National and International 374–76 (2d ed. 1950); F. Mann, *id.* at 339–40. This is also true of Japanese law. *See infra* notes 175–76 and accompanying text.

[118] *See generally* Uniform Commercial Code, *id.*, § 2–615 ("Excuse by Failure of Presupposed Conditions"); Restatement (Second) of Contracts §§ 454–69; White & Summers, *id.*, § 3–9. *See infra* note 146.

2. Foreign Exchange as "Commodity": The "Sale of Goods" Characterization

The question of whether foreign exchange, in the FCO context, is properly viewed as a "commodity" is an issue which is highly relevant to FCO breaches and which, as Dr. Mann has observed in each of the four editions of his influential book, "is everywhere a subject of discussion."[119] The question can become important because if a seller's breach is a breach of a contract to sell goods, the code provisions of many jurisdictions are quite specific, and often exclusive, as to the remedies available to a buyer. Similarly the law of some jurisdictions will recognize, in sale of goods cases, the defense of excuse of *force majeure* (or impossibility, or frustration of purpose) in favor of the defaulting seller,[120] and will supply a clear remedy where counterfeit money is delivered by analogy to the law of delivery of defective goods.[121] Remedies of rescission or specific performance will be disfavored. On the other hand, where foreign exchange is recognized rather as being "money," as a measure of wealth and a medium of exchange,[122] then an obligation to pay it is more likely to be specifically enforced, the reasoning underlying the "home currency" and "breach date/judgment date" controversies, addressed below, loses its force,[123] and the *force majeure* defense becomes superfluous.

One cannot do better, in approaching this controversy, than to begin with Dr. Mann's famous conclusion:

> This problem does not admit of a rigid solution. In the same way as the meaning of money may vary, and as a chattel which usually is money may sometimes be a commodity, so the question whether foreign money is to be treated as a commodity or money depends on the circumstances of the case, on the import of the words of a statute or an agreement, or on the legal nature of the individual transaction. Foreign money may be money, but it is not always money. Commodity is not a legal, but an economic concept; a commodity is that which is an object of commercial intercourse. But the conception of a commodity has a relative character; it cannot be attributed to any particular thing as such. Thus foreign money is dealt in and quoted on the foreign exchange market, and is therefore a commodity. On the other hand, foreign money very often serves the same functions as domestic money; it serves as a medium of exchange and is used for the purpose of the other functions fulfilled by the domestic currency which have been described as secondary functions. This view that no hard-and-fast rule exists and that foreign money is a commodity where it is, or is referred to as, an object of commercial intercourse, and that it is money where it serves

[119] F. Mann, *supra* note 61, at 185.

[120] *See, e.g.*, Uniform Commercial Code, *supra* note 116, § 2–615.

[121] *See* F. Mann, *supra* note 61, at 191, n.38; A. Nussbaum, *supra* note 117, at 320. *Cf.* Uniform Commercial Code, *supra* note 116, §§ 2–713 through 2–717 (supplying remedies).

[122] *See generally* F. Mann, *supra* note 61, at 1–28 (surveying concepts of money).

[123] *See, e.g.*, F. Mann, *id.* at 66.

> monetary functions, makes it necessary to examine each individual case and to refrain from over-rating the importance of statements made or conclusion arrived at in the one or the other connection.[124]

In the United States there are "innumerable"[125] cases in which foreign money has been described as a commodity, but usually such language has occurred in the distinguishable context of being used to support the view that the conversion into dollars for judgment purposes should be effected in accordance with the "breach date" rule discussed below.[126] There is also precedent in favor of the view that foreign exchange is "goods" for purposes of the applicability of Article 2 of the Uniform Commercial Code, dealing with contracts for the sale of goods[127] (although it also seems clear that foreign exchange—which is included in the term "money"[128]—is not goods for Article 9 security interest purposes[129] and would not be deemed to be goods when it is being used as the consideration to be paid for other goods).[130] The leading contemporary case for this proposition is arguably of limited value, since in it the New York Court of Appeals merely affirmed, in a memorandum decision without comment, a decision below in which the lower court assumed rather than squarely held that Article 2 applied.[131] If it is

[124] F. Mann, *id.* at 185 (footnotes omitted).

[125] *Id.* at 185, n.8.

[126] *Id. See infra* notes 177–95 and accompanying text.

[127] Uniform Commercial Code, *supra* note 116. Article 2 of the Code applies to "transactions in goods." UCC § 2–102. "Goods" means "all things ... which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities ... and things in action." UCC § 2–105. Comment 1 appears to be virtually dispositive on the drafters' intent that foreign exchange is goods for the purpose of triggering the applicability of Article 2; the relevant paragraph states:

> The exclusion of "money in which the price is to be paid" from the definition of goods does not mean that foreign currency which is included in the definition of money may not be the subject matter of a sales transaction. Goods is intended to cover the sale of money when money is being treated as a commodity but not to include it when money is the medium of payment.

See also infra note 131.

[128] "Money" means "a medium of exchange authorized or adopted by a domestic or foreign government as a part of its currency." UCC §§ 1–201(24). *See also* UCC § 3–107.

[129] UCC § 9–105 (i)(h) makes clear that the term "does not include money." A security interest in money can be perfected only by possession. UCC § 9–304.

[130] UCC § 2–105. The price can be payable in goods as well as in money. UCC § 2–304.

[131] United Equities Co. v. First Nat'l City Bank, 374 N.Y.S.2d 937 (Sup. Ct., N.Y. Co. 1975), *rev'd on other grounds*, 52 A.D.2d 154, 383 N.Y.S.2d 6, *aff'd*, 41 N.Y.2d 1385 (1977) (mem.). In April 1971 the plaintiff agreed to purchase forward yen in October at a fixed price. The "Nixon devaluation" occurred in August. The contract provided for an automatic three months' extension of the delivery date if circumstances beyond the seller's control prevented delivery. The contract called for delivery of the yen in Japan, which the buyer could not legally take due to an intervening change in Japanese law. The bank offered several substitutions of performance, each of which was rejected. The Appellate Division panel, reversing the court below, held that the bank's tender was reasonable, as was its unilateral offset of the transaction on the scheduled maturity date on which it paid the buyer its full profit on the transaction into a New York dollar account. The buyer could not claim for itself the benefit of the *force majeure* clause and extension and reap the additional yen appreciation that ensued during that subsequent three-month period. Both the trial and appellate court treated the case as

ultimately decided that Article 2 does apply to foreign exchange contracts and thus to FCOs, the legal consequences are, with one notable exception, not serious, since Article 2 generally sets forth principles which are consistent with the broad pattern of at least United States and British contract law generally. Thus the Statute of Frauds will require a writing signed by the party to be charged (as to which a telex will suffice and a written unilateral confirmation signed by the other party and not responded to will usually be effective);[132] the usual remedies for the holder will be cover and damages rather than specific performance;[133] the parties may, within limits of reasonableness, vary the damages formula or liquidate damages by agreement;[134] there will be a right to adequate assurances of performance where one party is reasonably led to doubt the other's ability or intention to perform;[135] and the Code's doctrine of anticipatory repudiation will apply.[136] None of these consequences, in the writer's judgment, frustrates normal commercial expectations in the foreign exchange markets. The notable exception referred to above, however, is the *force majeure* doctrine addressed separately below.

In the United Kingdom, similarly, the issue remains unsettled but probably without serious consequence. A contract to sell foreign exchange (or an FCO) is most probably not within the Sale of Goods Act, 1979, since section 61 of the Act defines "goods" as "all chattels personal other than things in action and money."[137] Foreign currency would probably be within the exclusion for money;[138] and if bank notes were sold, they would fall into the exclusion for "things in action."[139] Apart from this statutory issue, it is true that some British judicial decisions have referred to the sale of foreign exchange as the sale of a commodity.[140] But Dr. Mann's conclusion that a contract for the payment of

governed by Article 2 of the Uniform Commercial Code. *See also* Kerr S.S. Co., Inc. v. Chartered Bank of India, 292 N.Y. 253, 54 N.E.2d 813, 48 N.Y.S.2d 43 (1944) (foreign exchange a commodity). *But cf.* Matter of Lendle, 250 N.Y.S. 502, 166 N.E. 182 (Sup. Ct. 1929) (rejecting commodity theory of money). *Cf.* A. Corbin, Contracts § 480 (1950) (foreign money as goods, wares and merchandise).

132 *See* Uniform Commercial Code, supra note 116, § 2–201; White & Summers, *supra* note 116, ch. 2 (especially § 2–4).

133 *See* Uniform Commercial Code, *supra* note 116, §§ 2–712, 2–713, 2–716; White & Summers, *supra* note 116, ch. 6. "Cover" refers to a buyer's right, when a seller defaults, to make any reasonable purchase of substitute goods and then recover from the seller the difference between the actual cost of cover and the contract price. Alternatively such a buyer may elect to recover damages alone, measured as the difference between market price at the breach and contract price.

134 *See* Uniform Commercial Code, supra note 116, §§ 2–718, 2–719, White & Summers, *supra* note 116, at §§ 406, 12–8 through 12–12.

135 *See* Uniform Commercial Code, *supra* note 116, § 2–609.

136 *Id.* § 2–610.

137 Sale of Goods Act, 1979.

138 *See* Halcyon the Great (1975), 1 W.L.R. 515; Rhokana Corporation Limited v. Inland Revenue Commissioners, [1938] A.C. 380; Ehrensperger v. Anderson, (1848) 3 Exch. 148; Harrington v. MacMorris, (1813) 5 Taunt 228; F. Mann, *supra* note 61, at ch. 7.

139 F. Mann, *supra* note 61, at 191, n.38.

140 *See, e.g.*, In re British American Continental Bank Ltd., Goldzieher & Penso's Claim, [1922] 2 Ch. 575; Lisser & Rosenkranz's Claim, [1923] 1 Ch. 276. *See also* cases collected in F. Mann, *supra* note 61, at 192, n.45.

foreign money is properly analyzed as a monetary obligation or a debt rather than as a contract to sell a commodity is now firmly established by the reasoning underlying the decision of the House of Lords in *Miliangos v. George Frank (Textiles) Ltd.*,[141] discussed below.

The issue remains similarly unclear under Japanese law, but without any obvious serious consequences. The provisions of the Civil Code applicable to sales of property probably apply as well to foreign currency options, since "property" is broadly defined to include all objects of sales contracts[142] and since the provisions of the Civil Code on sales are expressly made applicable to other onerous contracts "to the extent they correspond to the nature of" such other contracts.[143] But the specific sales provisions in question either are inapplicable by their terms or are of little consequence to FCOs.[144] (The *force majeure* question is a separate and very serious issue and is addressed below.)

Finally, it is not entirely clear whether FCOs would be covered by the new United Nations Convention on Contracts for the International Sale of Goods. The Convention does not expressly define either "sale" or "goods." Article 2 of the Convention does, however, expressly exempt "money" from coverage, and in light of the Convention's international nature and the juxtaposition of the term "money" with stock, shares, investment securities and negotiable instruments, it seems almost certain that foreign exchange contracts and options are not covered by the Convention. If it did apply, the consequences are unlikely to be significant except as to the availability of specific performance and as to *force majeure*.[145]

[141] [1976] A.C. 443. *See* In re United Railways of Havana and Regla Warehouses Ltd., [1961] A.C. 1007; Syndic in Bankruptcy v. Khayat, [1943] A.C. 507; Cohn v. Boulken (1920), 36 T.L.R. 767; Choice Investments Ltd. v. Jeromnimon & Midland Bank Ltd., [1981] Q.B. 149.

[142] Civil Code of Japan Art. 555.

[143] *Id.* Art 559.

[144] Provisions for sales contracts are found in Civil Code Art. 560–85. Art. 579–85 deal with real property and Art. 560–72 provide for seller's liabilities only in connection with certain specified types of goods unrelated to FCOs; thus these are irrelevant. Similarly, Art. 576–78 are unrelated. Art. 558 (costs of the contract) and 573–74 (where and when to pay) are displaced when the parties have otherwise agreed, which would normally be the case with FCOs. Art. 555 defines formation of a sales contract (when one party promises to transfer certain property and the other promises to pay for it); no writing is required. Art. 556 does deal with options and provides that the holder may exercise and thus form a sales contract by a declaration of intention; it also fills the gap for duration when the parties have not specified maturity ("a reasonable period"). Art. 557 deals with down payments and installment payments, while Art. 575 provides for certain sales contract payment rules where the parties have not otherwise agreed.

[145] The Convention applies to covered transactions unless the parties exclude it. It rejects the "perfect tender" rule and allows rejection of goods only if their tender is a "fundamental" breach. Specific performance and rescission are equally favored remedies with damages, reflecting the civil law preference. A buyer is permitted to reduce the price of non-conforming goods. As to *force majeure*, the Convention excuses either party's performance if the failure is due to an "impediment," which is undefined. Damages formulas are quite similar to the U.S. Uniform Commercial Code. *See generally* text of Convention at March 2, 1987 Fed. Reg.; J. Honnold, Uniform Law for International Sales under the 1980 United Nations Convention (1982); R. Kathrein & D. Magraw (eds.), The Convention for the International Sale of Goods (1987).

In short, the issue of whether a contract or option on foreign currency is a "sale of goods" is usually a red herring and of little consequence. Generally, the applicable code will merely reflect general principles of contract law without affecting the outcome. And generally courts will reason by analogy to the relevant sales code even if it is not literally applicable. There are occasions, however, when the issue can become critical: the *force majeure* provisions of the Uniform Commercial Code and of the United Nations convention are the most dramatic examples.

3. Force Majeure

As noted, one of the consequences of treating foreign exchange as a commodity is to make it more likely that a court will recognize, given a default in payment, the defense or excuse of impossibility (also known as frustration of purpose or commercial impracticability or *force majeure*, and of which the defense of supervening illegality can be viewed as a subset). As an abstract doctrine, the defense is recognized in all three jurisdictions under consideration in cases where it may be concluded that a party was prevented from rendering a promised performance by the intervention of events which were both beyond his control and not reasonably forseeable as the time he entered into the contract.[146] This is especially true of the United States, where treatment of foreign exchange as "goods" will trigger a relatively relaxed version of the doctrine (in formulation, if not in application) under the Uniform Commercial Code called "commercial impracticability."[147]

[146] *See generally* Farnsworth, *Disputes Over Omissions in Contracts*, 68 Colum. L. Rev. 860 (1968); Hurst, *Freedom of Contract in an Unstable Economy: Judicial Reallocation of Contractual Risks under UCC Section 2–615*, 54 N.C. L. Rev. 545 (1976); Note, 72 Nw. U. L. Rev. 1032 (1978); Schwartz, *Sales Law and Inflation*, 50 So. Calif. L. Rev. 1 (1976); Duesenberg, *Contract Impracticability*, 32 Bus. Law. 1089 (1977); White & Summers, *supra* note 113, § 3–9; Restatement (Second) of Contracts §§ 454–69.

[147] Uniform Commercial Code § 2–615 provides as follows:

Except so far as a seller may have assumed a greater obligation and subject to the preceding section on substituted performance:

(a) Delay in delivery or non-delivery in whole or in part by a seller who complies with paragraphs (b) and (c) is not a breach of his duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid.

(b) Where the causes mentioned in paragraph (a) affect only a part of the seller's capacity to perform, he must allocate production and deliveries among his customers but may at his option include regular customers not then under contract as well as his own requirements for further manufacture. He may so allocate in any manner which is fair and reasonable.

(c) The seller must notify the buyer seasonably that there will be delay or non-delivery and, when allocation is required under paragraph (b), of the estimated quota thus made available for the buyer.

The language of the Code on this point was clearly chosen to "liberalize" *force majeure* law. Nevertheless, courts have generally been most reluctant to recognize excuse under this section. *See, e.g.*, authorities cited in note 146, *supra*. No case has been found where the section was applied to a foreign exchange contract. Although literally the section addresses sellers only, many have observed that its philosophy is equally applicable to buyers. Regarding payment *force majeure*, the useful comparison is with UCC §§ 2–614(2), which provides that "If the agreed means or manner of payment fails because of domestic or foreign governmental

On the other hand, there exists a body of opinion, particularly associated with Dr. Mann and Professor Nussbaum, which holds that one consequence of recognizing the character of foreign currency as genuine money is that "it can never be impossible to perform monetary obligations. They are ... indestructible. Neither circumstances peculiar to the debtor ... nor circumstances arising from developments in the monetary system ... ever relieve the debtor of his duty to pay."[148] This is stated to be true of a money debt (damages) under the Japanese Civil Code,[149] but neither the statute, the cases nor the literature appear to address the question of whether a foreign currency payment obligation is a "money debt" or damages for this purpose.

The extreme view of nonrecognition of *force majeure* in monetary obligations cases is almost surely not an accurate statement of British law. Thus in the earlier case of *Ralli v. Compania Nariera Sota y Aznar*,[150] a contract provided for a freight payment to be made in Spain, but an intervening Spanish statute made it illegal to either make or take the payment. The obligee's suit was dismissed by the court, applying English law, on the ground that "Where a contract requires an act to be done in a foreign country, it is in the absence of very special circumstances an implied term of the continuing validity of such a provision that the act to be done in the foreign country shall not be illegal by the law of that state." Or, as more recently put by Staughton, J. in *Lybian Arab Foreign Bank v. Bankers Trust Co.*,[151] "... English law currently recognizes that an obligation to pay money can be frustrated." Similarly, United States courts clearly recognize some applications of the law of *force majeure* to monetary obligations in the context of supervening

regulation, the sellers may withhold or stop delivery unless the buyer provides a means or manner of payment which is commercially a substantial equivalent. If delivery has alrady been taken, payment by the means or in the manner provided by the regulation discharges the buyer's obligation unless the regulation is discriminatory, aggressive or predatory."
Although the general residual rule of the Code favors freedom of contract (*see* UCC §§ 1–102(3) and (4)), it is not at all clear that parties can validly contract out of the *force majeure* provisions, entailing as they do obligations of good faith and reasonableness.

148 F. Mann, *supra* note 61 at 66. *But see id.* at 111 ("... no reason to assume that a serious and sudden depreciation of monetary value ... can never be regarded as a supervening change of circumstances ...") *See also id.* at 273, 420–21; A. Nussbaum, *supra* note 117, at 144.

149 Civil Code of Japan Art. 419(2). *Cf.* Art. 534 (if performance of obligation impossible for cause for which neither party is responsible, obligor is not entitled to counterperformance). Quotations in English of the Civil Code are from the 1966 English translation under authorization of the Ministry of Justice and the Codes Translation Committee, Eibun-Horei Sha, Inc., Tokyo.

150 (1920) 2 K.B. 287.

151 Queen's Bench Division, Commercial Court, Judgment dated September 2, 1987 by Staughton, J. slip op. at 28. The court denied the U.S. defendant its claimed excuse of illegality for failure to repay a deposit by the Lybian Bank in the face of a presidential "blocking order" in respect of assets or claims of Lybia or its agencies on the ground of its conclusion that there were alternate means of payment which were valid under the law in effect at the place of performance (i.e., England).

illegality. This may be seen, for example, in cases which give effect to foreign exchange control laws[152] and to the abrogation of so-called gold clauses,[153] as well as in the substitute payment provision of the Uniform Commercial Code's Article on Sales.[154]

In principle, Dr. Mann's view is surely the correct one. Any other view would make a shambles of the international credit markets, totally frustrating commercial understanding and expectations. Were it otherwise, bankruptcy laws—a kind of formal embodiment of the impossibility defense in the context of payment obligations—would be largely unnecessary. Acceptance of this principle makes it important that the "commodity theory of money" not be adopted in the context of the American Uniform Commercial Code lest so weak and malleable a concept as "commercial impracticability" become a legitimate basis for disavowing an obligation to pay foreign exchange. At the same time, the Mann formulation should probably be modified to recognize only that form of the *force majeure* defense which involves illegality of the payment; even then the defense should be allowed to operate not as a discharge of the obligation, as it apparently operated in the *Ralli* case, but only as a suspension of the payment obligation, an interpretation which some language in Dr. Mann's treatise seems to permit.[155]

C. Remedies and the Currency of Damages

The issue addressed here can be seen most plainly in a hypothetical. On January 1, Cat Corp., a corporation validly established under the laws of Mush, purchases from Dog Co., for a cash premium, an option to purchase on June 1 1500 gams (the legal currency of Moot) for 10 mushies (the legal currency of Mush). On January 1, the spot rate is 1 mushy=150 gams. On June 1, the spot rate is 1 mushy=100 gams. Cat exercises its option. Dog defaults. May Cat demand payment in mushies? May Dog elect, if it wishes, to make payment in mushies?[156] Is it correct that Cat's damages are 500 gams (i.e., the

[152] *See, e.g.* French v. Banco Nacional de Cuba, 23 N.Y.2d 46 (1968). *See generally* authorities and analysis at F. Mann, *supra* note 61, ch. 15. *Cf.* Wells Fargo Asia Ltd. v. Citibank, N.A., Memoranda and Orders dated May 28, 1987 and April 22, 1988 (S.D.N.Y. 84 Civ. 996) (applying New York law and denying impossibility-illegality defense where defendant bank obligated to use worldwide assets to satisfy Manila depositor's claim and failed to seek central bank approval in face of Philippine government decree forbidding repayment of foreign currency obligations without prior approval of central bank).

[153] *See, e.g.*, Ubersee Finanz Corp. A.G. v. Rosen, 83 F.2d 225 (2d Cir. 1936); Compania de Investiones v. Industrial Mortgage Bank of Finland, 269 N.Y. 22, 198 N.E. 617, *cert. denied*, 297 U.S. 705 (1936). *See generally* F. Mann, *supra* note 61, at 171–75, 290–304.

[154] See Uniform Commercial Code, *supra* note 116, §§ 2–614(2), quoted in note 147, *supra*.

[155] *Cf.* F. Mann, *supra* note 61, at 421.

[156] Since this point is tangential to the principal point regarding damages to be developed here, let me try to save the reader suspense on it. If either United States or United Kingdom law governs probably Dog, but not Cat, may elect that payment be made in either gams or mushies (unless the governing instrument specifies that the payment may be made only in gams). *See* Uniform Commercial Code, *supra* note 116, § 3–107 (by analogy); Art. 41, Uniform Law on Bills of Exchange and Notes (League of Nations, Official Journal, xi (1930), 993); ART. 36, Uniform Law on Cheques (League of Nations, Official Journal, xii (1931), 802). That is, the debtor

1500 gams it would have received under the contract minus the 1000 gams it can now buy in the market for 10 mushies) or, converted into mushies as of the breach date, 5 mushies? In which currency may or should or must a court of Mush award damages? May the court grant specific performance? Must or should it, if requested?

It gets worse, of course. On September 1, with the mushy rapidly depreciating, 1 mushy (spot)=50 gams. A court of Mush (a very efficient one with an uncrowded docket) enters judgment against Dog for breach of contract. Should judgment be entered for 5 mushies? But today 10 mushies (the option's strike price) will only buy 500 gams, so Cat's damages are arguably 1000 gams or, converting into mushies as of the judgment date, 20 mushies. And what of the questions raised above?

On December 1, the spot rate is 1 mush=10 gams, so 10 mushies will now only purchase 100 gams. Dog proposes to now pay Cat its damages. Cat insists that its damages, measured today, are 1400 gams or, converted as of the payment date, 140 mushies. And, of course, what of all the questions raised above? And what if, instead of depreciating, the mushy had appreciated against the gam over the period?

1. Legal Tender and the "Home Currency" Rule

Based on a questionable reading[157] of section 20 of the Currency Act of 1792,[158] which was amended in 1982 to delete the reference to "court proceedings" as being surplusage,[159] United States courts followed earlier British practice and adopted the home currency rule as laid down in two opinions by Justice Holmes.[160] Under the rule, foreign currency claims must be converted to dollar judgments. The rule has become the received learning in the federal courts[161] and at least eighteen states have statutes with language which may be construed to require a home currency rule judgment.[162] (Of the latter, New York's situation is surely the most striking, if not bizarre, in light of its commercial importance.)[163]

may choose to pay in the currency of the place of payment at the rate of exchange on the date of maturity. But if the debtor delays the payment, then under U.K. law, the creditor may select whether payment is to be made at the rate of that day or at that of the day of payment. *Id.* Under U.S. law, the creditor then acquires an optional right to payment in dollars calculated at the exchange rate at the breach date. *Hicks v. Guiness*, 269 U.S. 71 (1925). *See also* F. Mann, *supra* note 61, at 306–21. *Cf. Lybian Arab Foreign Bank v. Bankers Trust Co., supra* note 151, at 51–54.

157 *See* analysis suggested at Brand, *supra* note 116, at 157–59.

158 31 U.S.C. § 371 (1982).

159 Pub. L. 97–258, 96 Stat. 877, 1067 (1982), codified at 31 U.S.C.A. § 5101 (West Supp. 1984). On the surplusage point, *see* H. Rep. No. 651, 97th Cong., 2d Sess. 146.

160 Die Deutsche Bank filiale Nurenburg v. Humphrey, 272 U.S. 547 (1926); Hicks v. Guiness, 269 U.S. 71 (1925).

161 *See, e.g.*, Shaw, Sarill, Albion & Co. v. The Fredricksburg, 189 F.2d 952 (2d Cir. 1951); Jamaica Nutrition Holdings v. U.S., 643 F.2d 376 (5th Cir. 1981); Int'l Silk Guild, Inc. v. Rogers, 262 F.2d 219 (D.C. Cir. 1958).

162 The jurisdictions are surveyed at Brand, *supra* note 116, at 169.

163 New York has always been associated with the home currency rule. Indeed it alone refused to enact the sentence in UCC § 3–107(2), which provides that an instrument may validly specify that it is to be payable only

The home currency rule had its origin in an 1898 English case.[164] As recently as 1961 a British court could state forcefully that "[I]f there is one thing clear in our law, it is that the claim must be made in sterling and the judgment given in sterling."[165] The rule, a major departure from Continental rules favoring specific performance[166] and the granting of judgment in the foreign currency promised,[167] was severely criticized in the literature and chipped away at in the case law development.[168] Finally in 1975 in the remarkable piece of judicial legislation called *Miliangos v. George Frank (Textiles) Ltd.*,[169] by giving judgment in a foreign currency the House of Lords abolished the home currency judgment rule (and the breach date rule, discussed below, as well). The grounds of the decision were left vague, and the holding was expressly limited to judgments on a debt expressed in a foreign currency in which the money of account, the money of payment and governing law were all foreign. But subsequent cases have expanded the *Miliangos* holding so that the money of account[170] and governing law[171] requirements were dropped, and the new rule extended to breach of contract cases generally[172] as well as to damages in tort.[173]

Japanese law is not clear on the issue. The parties to a contract can agree how damages should be awarded. Absent such agreement, a court must award damages in "money,"[174] leaving unresolved the issue of whether foreign currency is "money" for this purpose. It seems probable that a Japanese court could award damages in a foreign currency since either a debtor or creditor can elect to have a foreign currency debt converted into yen[175] and since a Japanese court can freely award specific performance

in a specified foreign currency. *See* Brand, *supra* note 116, at 175. Less than a year ago, however, New York adopted a statute which overturns the home currency rule and apparently requires a court to enter judgment in foreign currency where the cause of action is based on a foreign currency. But the next sentence incomprehensibly requires that the judgment then be converted into dollars as of the judgment date. The statute amends section 27 of the N.Y. Judiciary Law. *See* ch. 211, McKinney's Session Laws of N.Y. at 491, effective July 20, 1987. *See infra* note 181.

164 Manners v. Pearson & Son, [1898] 1 Ch. 581 (C.A.).

165 *Re* United Railways of the Havana & Regla Warehouses, 1961 A.C. 1007.

166 *See* A. Nussbaum, *supra* note 117 at 374–76; F. Mann, *supra* note 61, at 339–40.

167 *See, e.g.*, F. Mann, *supra* note 61, 2d and 3d ed.; A. Nussbaum, *supra* note 117, at 370; 3 E. Rubel, The Conflict of Laws 29 (2d ed. 1958); M. Wolff, Private International Law 461 (2d ed. 1945).

168 *See generally* F. Mann, *supra* note 61, ch. 12; Brand, *supra* note 116.

169 1976 A.C. 443.

170 George Vefling's Rederi A/S v. President of India, [1979] 1 All E.R. 380 (C.A.).

171 Barclay's Bank Int'l Ltd. v. Levin Bros. Bradford Ltd., [1976] 3 All E.R. 900 (Q.B.).

172 The Folias, 1979 A.C. 685 (H.L.).

173 The Despina R., 1979 A.C. 685 (H.L.).

174 Civil Code of Japan Art. 417.

175 *Id.* Art. 403. The provision refers to the debtor's right of conversion. The Supreme Court of Japan has construed the right to be applicable to creditors as well. Supreme Court Judgment, July 15, 1975, Reporter on Civil Cases vol. 29, no. 6, p. 1029. *See also* Civil Code of Japan Art. 402 (if subject of claim is money, obligor "may at his option effect payment in currency of any kind; however, this shall not apply to cases where the delivery of a specific kind of currency is made the subject of the claim.")

under Japanese contract law (and indeed must do so where the creditor seeks it).[176]

2. *The Date of Conversion*

Once a version of the home currency rule is adopted in a jurisdiction, the next logical question becomes: as of what date should the conversion into the home currency be made (the point, of course, of the extended case hypothesized above). The two opinions of Justice Holmes alluded to above have generally been interpreted to provide that, if a foreign currency liability is payable or otherwise arises in the United States, courts will convert at the exchange rate in effect on the date of breach of contract or other injury (the "breach date rule"),[177] while if the same obligation arises in a foreign jurisdiction, courts will treat it as arising under foreign law and convert at the rate existing on the date the judgment is entered in the United States (the "judgment date rule").[178] Most state courts have followed New York[179] and adopted an across-the-board breach date rule; but there have been variations.[180] New York represents confusion compounded in that a recent statutory change which makes little sense apparently overrules the breach date rule but supplants it with a judgment date rule.[181] The Restatement (Second) of Conflict of Laws adopts generally the judgment date rule.[182] The breach date rule appropriately protects the reasonable expectations of the non-breaching party when the home currency of the forum has been the stronger currency over time; the judgment date rule does so when the home currency has been the weaker. Neither is consistently appropriate in all circumstances,[182] and neither provides an independent and principled answer to the questions of when interest should begin to run or whether (and how) delay damages should be calculated.[184]

[176] Civil Code of Japan, Art. 414; Civil Procedure Code of Japan, Art. 186.

[177] Hicks v. Guiness, 269 U.S. 71 (1925).

[178] Die Deutsche Bank filiale Nurenberg v. Humphrey, 272 U.S. 517 (1926).

[179] *See, e.g.*, Hoppe v. Russo-Asiatic Bank, 235 N.Y. 37, 138 N.E. 497 (1923); Gross v. Mendel, 225 N.Y. 633, 121 N.E. 871 (1918), *aff'g* 171 App. Div. 237, 157 N.Y.S. 357 (1916); Kantor v. Aristo Hosiery Co., 248 N.Y. 630, 162 N.E. 553 (1928), *aff'g* 222 App. Div. 502, 226 N.Y.S. 582 (1928); Sokoloff v. National City Bank of New York, 250 N.Y. 69, 164 N.E. 745 (1928); Parker v. Hoppe, 257 N.Y. 333, 178 N.E. 550 (1931).

[180] *See, e.g.*, Perutz v. Bohemian Discount Bank, 279 A.D. 386, 110 N.Y.S.2d 446 (1952) (judgment date rule based on stipulation); De Sayre v. De La Valdene, 125 N.Y.S.2d 143 (Sup. Ct. 1953). *See also* F. Mann, *supra* note 61, at 343–47.

[181] Section 27 of the N.Y. Judiciary Law has been amended by the addition of a new subsection (b), which reads: "In any case in which the cause of action is based upon a currency other than currency of the United States, a court shall enter or render a judgment or decree in the foreign currency of the underlying obligation. Such judgment shall be converted into currency of the United States at the rate of exchange prevailing on the date of entry of the judgment or decree." McKinney's Sess. Laws of N.Y., 210th Assembly, ch. 211, effective July 20, 1987.

[182] *But see* F. Mann, *supra* note 61, at 345 (interpreting Restatement as adopting Holmes position).

[183] *Cf.* Brand, *supra* note 116, at 141.

[184] Professor Leary is clearly correct that these are separate issues, but ones which must also be addressed. Leary & Casey, *Fluctuating Currencies: Obligations Payable in Foreign Moneys*, N.Y. State Bar J. Jan. 1988, at 16, 18, 24. *Cf.* F. Mann, *supra* note 61, at 348 (apparently in accord).

British law on the currency conversion point had a long (and rather tedious) development until the 1975 decision of the House of Lords in the *Miliangos* case abolishing the home currency rule. This long and tortuous history is described and criticized elsewhere.[185] A summary of the current state of British law is offered as follows by Dr. Mann:

> It is now clear that English law does not require any foreign money obligation to be converted into sterling for the purpose of instituting proceedings or of the judgment; on the contrary, where the plaintiff claims a sum of foreign money, he is both entitled and bound to apply for judgment in terms of such foreign money and it is only at the stage of payment or enforcement that conversion into sterling at the rate of exchange then prevailing takes place. This is so whether the claim is for payment of a specific sum contractually due or for damages for breach of contract or tort or for a just sum due in respect of unjustified enrichment, or for restitution. Nor does it matter whether the contract sued upon is governed by English or by foreign law. Nor is it necessary to ask for specific performance rather than payment: in either case the defendant will be ordered to pay foreign money. Moreover an award in an English arbitration may be expressed and enforced in foreign currency and a foreign award or judgment so expressed may be enforced like the English award or judgment. Certain statutory provisions are designed to ensure similar results in the fields of law covered by them. In short, in the realm of legal proceedings foreign money is being treated in almost exactly the same way as sterling.
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> . . . .
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> If the foreign currency depreciates in terms of sterling the law as it stands allows the creditor to recover the amount of foreign currency he is entitled to and does not attempt to compensate him for the loss which he suffers as a result of the debtor's default in discharging his obligations. The consequences of that default have to be decided upon, not by the law of procedure which is concerned with the enforcement rather than the creation of rights, but by the proper law of the contract or the substantive law governing the particular obligation under consideration. Where the applicable law is English it is, therefore, most important in the interest of justice and in accordance with suggestions made earlier in this book to develop a sound rule permitting the recovery of damages for the loss caused by the depreciation of foreign money—a rule such as many foreign countries have evolved and which, it is submitted, is or ought to be concomitant to the modern English law.
>
> If, on the other hand, sterling depreciates ..., the creditor of a foreign money obligation who brings proceedings in England is no longer penalized by

[185] This is done extensively and thoroughly in the 2d and 3d editions of F. Mann, *supra* note 61, ch. 12.

doing so: he will recover judgment for what he is entitled to without being prejudiced by a quirk of English procedural law.[186]

In short, the current English rule does away with both the home currency and the breach date rules; judgment will be entered in terms of the foreign currency, and if payment of the judgment needs to be enforced in sterling, then conversion will be effected as of the payment date.

The outcome under Japanese law is less clear. Consistent with the statements above, the probable outcome is that a Japanese court could grant specific performance of the foreign currency debt and thus could render judgment in foreign currency, but would be required to convert it into yen if either party so elects.[187] Conversion would likely be at the exchange rate in effect on the last day of trial (i.e., corresponding approximately to the judgment date rule).

3. *New Directions*

Thus far we have seen the adoption and application, as well as the abolition, of the home currency rule in several jurisdictions, together with conversion into the home currency at the breach date, the judgment date, and the payment date. Each has had its supporters and detractors in the literature,[188] and the operation of each is illustrated (albeit simplistically) in the hypothetical at the beginning of this section IV, C.

Encouraged, perhaps, by the dramatic changes in British law engendered by the *Miliangos* decision and its progeny, there have been several recent calls for law reform in the area, notably in the United States. Three are worth brief mention.

The first is the position expressed in the recently issued Restatement (Third) of Foreign Relations Law of the United States.[189] While recognizing that the home currency rule is the usual rule to be applied, the Restatement would give a court the power to give judgment in the relevant foreign currency and grant discretion to the court with respect to

[186] F. Mann, *supra* note 61, at 347–49 (citations omitted). "Delay damages" for actual loss suffered through sterling depreciation have never been recognized in England. *Id.* at 109.

[187] *See supra* notes 171–73 and accompanying text. As to both this point and the conversion date point in the following sentence in text, *see* Supreme Court Judgment, July 15, 1975, Reporter on Civil Cases vol. 29, no. 6, p. 1029.

[188] Authorities favoring judgment date rule include: Restatement (Second) of Conflict of Laws § 144 (1971); F. Mann, *supra* note 61, 1st ed. 1953 at 315 (*but see* 4th ed. 1982 at 325, 348, seemingly favoring a payment date rule); A. Nussbaum, *supra* note 117, at 372; Evan, *Rationale of Valuation of Foreign Money Obligations*, 54 Mich. L. Rev. 307 (1956); Fraenkel, *Foreign Moneys in Domestic Courts*, 35 Colum. L. Rev. 360 (1935).Authorities favoring breach date rule include: Eder, *Legal Theories of Money*, 20 Cornell L. Q. 52 (1934); Gluck, *The Rate of Exchange in the Law of Damages*, 22 Colum. L. Rev. 217 (1922).

Authorities favoring payment date rule include Leary & Casey, *supra* note 184; F. Mann, discussed *supra* in this note.

One writer favors the date suit was commenced. Jones, *The Spurious Judgment Day Rule for Converting Foreign Currency into Dollars*, 3 Int'l Law. 277 (1969). The current Restatement position and the Brand proposal are outlined *infra* at notes 189–98 and accompanying text.

[189] Restatement (Third) of the Foreign Relations Law of the United States § 823.

conversion if judgment is given in dollars. It gives the plaintiff the option of seeking judgment in the relevant foreign currency[190] (unlike the *Miliangos* rule which is interpreted to *require* that judgment be given in foreign currency but which is also interpreted by some to imply a payment date conversion rule when the judgment must be enforced in pounds.[191] An earlier draft of the Restatement position seemed flawed in that it limited the plaintiff to the breach date and judgment date rates and appeared not to permit payment date conversion.[192] This would not necessarily have been an improvement over the rigid payment date rule that appears to be the current U. K. rule and which, when conjoined with a mandatory and inflexible foreign currency judgment rule, will operate fairly with a weak sterling, but which can arguably be as unfair in periods of a strong pound as the breach date rule was in times of a weak pound. The final version of the Restatement clearly would permit payment date conversion.[193]

A second alternative has recently been put forward by Professor Leary,[194] who has urged that *state* laws be amended to overrule both the breach date and the judgment date rules and that these be replaced with a payment date rule (with appropriate provisions for "delay damages" to punish obvious recalcitrants and compensate a plaintiff for interim currency devaluations, inflation and the time-loss of its money), to be followed by a federal statute covering federal cases (e.g., admiralty cases). In fact a project on exactly this problem has recently been initiated by the National Conference of Commissioners on Uniform State Laws; a drafting committee has been formed and a Reporter hired (although no final decisions have yet been made on the outcome).

Finally, an alternative solution has been proposed by Professor Brand, designed to give maximum flexibility to the court as to the currency of judgment, to use the payment date rule for conversion where conversion must be made, to provide separately for delay damages arising in the case where the currency of judgment has depreciated with respect to any other currency related to the suit, and to require the court to calculate appropriate pre-judgment or post-judgment interest at rates calculated in terms of the currency in

[190] *Id.*, comments b and c.

[191] *See* F. Mann, *supra* note 61, at 348; Brand, *supra* note 116, at 180.

[192] Restatement (Revised), of Foreign Relations Law § 823, comment c, (Tent. Draft No.6, 1985).

[193] Restatement § 823, *supra* note 189. The issue is properly a separate issue of delay damages and should turn on appropriate proof that it was commercially forseeable that the plaintiff would have a reasonable commercial expectation of converting into home currency. In any event, it is avoided where the court has the discretion, based on plaintiff's proof, to award damages in either the foreign or the home currency as the factual context and equities may suggest. Put differently, the inquiry should first determine the currency in which the loss was incurred; the injured party should bear the currency risk only of the currency in which it operated and put at risk in the transaction, and damages should be awarded in that currency. *See* Leary & Casey, *supra* note 184, at 18, 20.

[194] Leary & Casey, *supra* note 184.

which judgment is rendered.[195]

The disciplined flexibility as to the currency of judgment offered by the Brand formulation, building as it does on the British experience and on the flaws of the draft Restatement provision, represents a substantial improvement over the current state of the law. Its incorporation of the payment date rule, and thus of the Leary formulation, where conversion must be made is important in that it best advances the ultimate policy goal of awarding damages in breach of contract cases—to fully compensate the non-breaching party for losses actually sustained[196] (or, in the drier language of the Restatement of Contracts, to put the injured party in "as good a position as that he would have been in had the contract been performed.")[197] And its separate treatment of delay damages for depreciation of the currency of judgment and interest is both sensitive to the specific needs of the injured party and sensible in not confusing what should be separate issues. In the particular area of foreign currency options, it would be improved by making clear that a court has authority to decree specific performance in appropriate cases and that the normal remedy in the case of a pre-exercise defualt by the grantor should be damages as compensation for all costs reasonably incurred in the holder's arms-length purchase of an option as nearly as practicable identical in terms, amount, currency and expiration date.[198]

[195] Brand, *supra* note 116, at 184–90. His proposed formulation is as follows.

Obligation in Foreign Currency: Law of the United States

(1) Courts in the United States may give judgment on causes of action arising in another state, or denominated in a foreign currency, in U.S. currency, in foreign currency, or in an amount in U.S. currency which is the equivalent of the amount of the obligation in the foreign currency at the time of payment.

(2) Courts should give judgment in the most appropriate currency, taking into consideration:

(a) the currency in which the obligation is denominated, if any ("currency of account/payment");

(b) the currency in which the loss was incurred ("expenditure currency");

(c) the currency used by the plaintiff to make payment for the loss when it occurred ("plaintiff's currency"); and

(d) The foreseeability of loss in a particular currency.

(3) If the currency in which judgment is given pursuant to subsections (1) and (2) has depreciated in value as compared to another currency which is related to the cause of action, a court may, in appropriate circumstances, award damages for the loss caused by the depreciation of the judgment currency.

(4) In giving judgment on a foreign currency obligation, a court may award both pre-judgment and post-judgment interest at such rate or rates as shall be appropriate, taking into consideration the statutory rate of interest, if any, otherwise applicable and the rate of interest generally available in the market on investments made in terms of the currency in which judgment is rendered.

[196] *See supra* note 116 and accompanying text. The payment date rule also reflects the civil law preference. Mann, *supra* note 61, at 339.

[197] *id.*

[198] The remedy reflects market practice in at least the New York FCO market. *E.g.*, it is incorporated in the current (May, 1987) draft USICOM terms. It also comports with the Uniform Commercial Code policy favoring "cover" as the preferred buyer's remedy. UCC § 2–712.

V. Summary and Conclusions

This paper began with an outline (in section II) of the explosive development during this decade of a variety of interlinked over-the-counter markets for foreign currency options centered in London, New York and Tokyo and the associated growth of smaller but nevertheless economically significant exchange-traded FCO markets beginning in late 1982. The functions and uses of FCOs were outlined, together with perceived advantages and disadvantages compared with other related instruments. Several new and novel FCO-based instruments were examined.

Against this backdrop of an accurate and current portrayal of what these instruments are and do and what economic roles they play in the markets today, section III undertook a description and evaluation of the key legal and policy issues associated with the regulatory question of who, if anyone, should be regulating the over-the-counter markets in foreign currency options. It was seen that in the United States, the crucial issue is whether jurisdiction of the Commodity Futures Trading Commission over the OTC markets in foreign exchange is excluded by the Treasury Amendment of the Commodity Exchange Act. While the issue is not yet resolved, the suggestion was made that the better-reasoned interpretation is that the CFTC lacks regulatory jurisdiction over these markets based on the Treasury Amendment (and secondarily on the Trade Option Exemption). The Amendment's language is absolute, and this interpretation comports with legislative history and intent. Nothing in the language or history conditions the jurisdictional exclusion on the sophistication or regulated nature of the parties. The judicial decisions which let the issue of the Amendment's applicability turn on the attenuated distinction between "transactions in" and "transactions involving" foreign currency seem unwarranted and, indeed, embarrassing. An inference of Congressional "adoption by silence" of these decisions would similarly be unwarranted and embarrassing.

The newly-emerging regulatory regimes of the United Kingdom and Japan were briefly contrasted. While it is too early to evaluate them, it seems clear that Bank of England regulation over these markets will remain considerably more light-handed than would the CFTC's over their U.S. counterparts. This appears likely to be the case in Japan as well, with Ministry of Finance and Bank of Japan focus more on participant solvency and safety rather than on specific functioning of the trading markets, and with the new financial futures exchange being structured as a self-regulatory organization subject to loose administrative guidance and supervision of the Ministry of Finance and Bank of Japan.

The absence of CFTC or equivalent regulatory jurisdiction over the institutional FCO markets was and remains—if the legal conclusions herein are ultimately accepted —the better policy choice, at least for the time being, for a variety of reasons. In the first place, these markets, which are almost exclusively wholesale and institutional, do not implicate the regulatory goal of consumer protection or the related objective of protection of participants against fraud. Consumers do not participate in these OTC markets, unlike the case of exchange markets, and the participants are quite able to fend for themselves.

Second, there is no substantial basis for a belief that the exclusion of CFTC-type direct market regulation would result in a regulatory vacuum. Most of the participants (banks, securities firms, Commodity Exchange Act regulated entities like futures commission merchants, and insurance companies come to mind) are already regulated, supervised entities, so that most FCO transactions in the institutional market will already be subject to at least indirect regulatory scrutiny, scrutiny which appropriately and effectively serves the separate policy goal of promoting financial stability.[199]

In the third place, if serious problems or abuses do develop in these markets, then of course it may become appropriate to superimpose on them another and more direct and pervasive regulatory layer. But there is no efficient purpose served in doing this prematurely, and if such needs arise then Congress (or Parliament, or the Diet, as the case may be) is in the best position to assess them and to determine an appropriate response. Absent evidence of such abuses, no useful purpose is served by any further proliferation of regulators.

Finally, all the evidence suggests that the institutional OTC market in currency and FCOs has originated and grown in an efficient and economically healthy manner without massive market regulation. At the same time this market has clearly not precluded and probably not even retarded the growth and development of exchange-traded FCOs, which appear to have functioned in a complementary manner to their OTC counterparts. Given this successful beginning, the burden of proving regulatory need should rest on its proponents, and they have not sustained it.

In section IV, the analysis of foreign currency options shifted away from the regulatory perspective and toward a contractual perspective, with the focus being particularly on the contract law of remedies. Specifically, two legal implications of the commodity theory of money on damages theory were explored: the defense (or excuse) of impossibility, and the home currency judgment rule. Several suggestions are ventured.

First, the better policy choice is to restrict operation of the *force majeure* doctrine wherever obligations to pay or repay money, whether as debt or pursuant to a contract, and whether foreign exchange or domestic currency, are concerned. The commodity theory of money and its legal implications are inconsistent with this policy and thus should be rejected or at least tightly restricted. Put differently, *force majeure* can and does make sense to excuse my obligation to provide and sell widgets to Bloomindale's or

[199] Thus, for example, U.S. and British bank regulators propose to incorporate credit risks on foreign currency transactions into their risk-based capital measure. *See* Proposal of Board of Governors of Federal Reserve System, March 18, 1987, 52 Fed. Reg. 9304, reprinted at Fed. Bank L. Rep. (CCH) ¶ 86,908. Regarding practice in Japan, *see supra* note 39.

Harrod's or Mitsukoshi because an unforseeable and uninsurable natural disaster levels my plant. But this doctrine makes no sense, and can only create mischief, in the world of money, banking and credit. The single plausible exception relates to intervening illegality of the payment, but this leads us into sovereign risk and moral obligation of states—policy issues far beyond the scope of this study.

Second, the home currency judgment rule has little justification in policy and should be given rapid burial. It is an intellectual corollary of the commodity theory of money and makes as little sense today.

Third, if the home currency rule is interred, it will be rare that the breach date rule controversy will need to be faced. Still, there will be occasions, in connection with the enforcement of judgments, when such conversions will need to be made. The breach date and judgment date rules should be rejected for similar reasons; neither bears any necessary relationship to compensating the plaintiff for actual losses sustained, and the choice of either is subject to the vagaries of the currency markets. A payment date rule comes closest to balancing the equities and effectuating the law's appropriate policy goal of compensation.

Fourth, the best balance of achieving these goals together in one framework rests in the Brand formulation, for the reasons developed in section IV. This formulation would be improved upon by modifying it to explicity authorize specific performance as a primary remedy, as it is in the Japanese and Continental systems, and to make clear that full compensation of the holder's actual losses sustained is the appropriate departure point for damages calculation. In most cases, where a conversion needs to be made, a payment date rule will come closest to the full compensation norm. Maintaining separate rules by which to calculate and award delay damages, would also serve to cover the rare case where a payment date conversion to plaintiff's appreciated home currency is demonstrably unfair to the plaintiff.

Fifth and finally, the linkage between the *laissez faire* response to the institutional OTC markets advocated in this paper and the remedial gaps noted above should not be ignored. Participants in these markets should be granted incentives to agree among themselves, not only as to their own preferred market custom and practices, but especially as to their own preferred remedies. Specifically, applicable law of each of the three jurisdictions studied herein honors liquidation of damages by the parties themselves,[200] so that efforts along these lines, such as by the International Swap Dealers Association and as seen in recent efforts initiated by OTC market participants to draft market terms and to shape preferred remedies, should be encouraged and enforced.

[200] *See, e.g.*, Uniform Commercial Code, *supra* note 116, §§ 2–718, 2–719; F. Mann, *supra* note 61, at 349; Civil Code of Japan Art. 420.