



United States
General Accounting Office
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General Government Division

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December 19, 1997

The Honorable Thomas J. Bliley
Chairman, Committee on Commerce
House of Representatives

Subject: OTC Derivatives: Lawsuits Involving Sales Practice Concerns

Dear Mr. Chairman:

This letter responds to a request made by your office during an October 16, 1997, briefing on our report OTC Derivatives: Additional Oversight Could Reduce Costly Sales Practice Disputes (GAO/GGD-98-5, Oct. 2, 1997). This report addressed sales practices related to over-the-counter (OTC) derivatives, mortgage-backed securities (MBS), and structured notes. It included a discussion of lawsuits involving sales practices concerns, and your office asked us to provide a list of these lawsuits that describes the allegations made and the case outcomes.

We produced the enclosed list from a database of 360 losses involving OTC derivatives, MBS, and structured notes which we had compiled while working on our report.¹ To address your office's request, we identified 13 OTC derivatives losses from this database that involved lawsuits in which the end-users had raised sales practice concerns. To determine the status of cases that were unresolved when we issued our report, we contacted staff from the relevant dealers and obtained information from public sources, including court

¹Our database of end-user losses was compiled from publicly available information and regulatory data, including information taken from periodical and industry publications, special studies, litigation reporting services, and regulatory case data. The list was limited to end-user losses directly involving the products included in our report: OTC derivatives (forwards, options, and swaps), MBS, or structured notes. It excluded losses that dealers incurred or losses incurred by foreign end-users transacting with foreign dealers. The number and total dollar amount of losses in this list may be overstated as a result of including unrealized losses or losses partially attributable to products other than those addressed in the report. These losses may also be understated to the extent that all losses were not publicly reported.

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documents, journal articles, and/or press reports. We did not seek agency comments on this letter because we had already received extensive comments from all interested parties as part of preparing our report.

The enclosure to this letter presents additional information on the 13 lawsuits involving OTC derivatives sales practices. Of the 13 lawsuits, 6 involved Bankers Trust and the remainder involved several U.S. securities firms. The claims made in the lawsuits generally included state-based claims of fraud, breach of fiduciary duty, and misrepresentation, but seven cases also involved claims under federal laws, including fraud and other claims under the Commodity Exchange Act (CEA) or the Securities Exchange Act of 1934 (Exchange Act). In addition, the end-users in four of the cases claimed that their personnel had not been authorized to enter into the transactions. Three of the 11 cases are ongoing.

It is our understanding, based on conversations with your office, that our recently issued sales practice report, our briefing to your office, and this letter respond to the questions raised in your November 14, 1995, request regarding OTC derivatives sales practices. We plan to distribute copies of this letter to the Ranking Minority Member of your Committee and the Chairman and Ranking Minority Member of the Subcommittee on Finance and Hazardous Materials. In addition, we will provide copies to the Commodity Futures Trading Commission, the Federal Reserve, and the Securities and Exchange Commission, as well as others on request.

Major contributors to this letter were Cecile O. Trop, Assistant Director; Cody J. Goebel, Senior Evaluator; and Melvin Thomas, Senior Evaluator. Please contact me at (202) 512-8678 or Cecile Trop at (312) 220-7705, if you or your staff have any questions.

Sincerely,



Thomas McCool
Director, Financial Institutions
and Markets Issues

Enclosure

OTC Derivatives Losses Involving Sales Practice-Related Lawsuits

No.	Entity or individual reporting losses	Loss amount (millions)*	Specific type of derivative product	Relevant lawsuit claims, defenses, or counterclaims	Dealer	Outcome of lawsuit
1	RCS Editori (Italy)	\$371	Interest rate and currency swaps	Fraud, breach of fiduciary duty, and fraud under Italian securities law	Bankers Trust	The parties settled for an undisclosed amount.
2	Henryk de Kwiatowski	\$300	Currency forwards and options	Breach of fiduciary duty; negligence; fraud; negligent misrepresentation; breach of contract; and various violations of the CEA, including fraud in connection with the sale of commodities for future delivery (section 4b), fraud by a commodities trading advisor (section 4o), and dealing in illegal off-exchange futures	Bear Stearns	Ongoing. In a ruling on the defendant's motion to dismiss, the U.S. District Court for the Southern District of New York allowed to stand the plaintiff's claims related to breach of fiduciary duty, negligence, and the count relating to fraud by a commodities trading advisor (section 4o). The court's ruling dismissed the claims of fraud, negligent misrepresentation, breach of contract, and the other CEA-related claims of fraud under section 4b and illegal futures dealing.
3	State of West Virginia	\$280	Treasury options	Fraud	Greenwich Capital Markets, Goldman Sachs, Morgan Stanley, NatWest Government Securities, and Salomon Brothers	The other dealers settled with the state for a total of \$28 million, but after a jury trial in the Circuit Court of Kanawha County, West Virginia, Morgan Stanley was ordered to pay the state \$56 million. The Supreme Court of Appeals of West Virginia overturned the lower court's ruling and ordered a new trial. Morgan Stanley subsequently settled with the state for \$20 million.

No.	Entity or individual reporting losses	Loss amount (millions) ^a	Specific type of derivative product	Relevant lawsuit claims, defenses, or counterclaims	Dealer	Outcome of lawsuit
4	Procter & Gamble	\$157	Interest rate swaps	Fraud, breach of fiduciary duty, negligence, misrepresentation, fraud in connection with the sale of a security under the Exchange Act, and violations of the CEA's general fraud section (4b) and fraud by a commodities trading advisor (4c)	Bankers Trust	In ruling on a motion by Bankers Trust, the U.S. District Court of the Southern District of Ohio dismissed or found in favor of the dealer on all securities and commodities law counts and left counts related to fraud and contract validity to be tried. On the day the ruling was issued, the two parties settled, with Bankers Trust forgiving about \$150 million of the \$200 million that it was owed by Procter & Gamble.
5	PT Dharmala Sakti Sejahtera (Indonesia)	\$64	Interest rate swaps	Misrepresentation, breach of contract, breach of duty of care, and transaction conducted with unauthorized end-user personnel	Bankers Trust	The Commercial Court of England ruled in favor of Bankers Trust, indicating that the dealer owed no duties beyond that of ensuring that the facts in any representations were made fairly and accurately. The parties subsequently settled for an undisclosed amount.
6	Minmetals	\$52	Currency options and swaps	Fraud, breach of fiduciary duty, transaction conducted with unauthorized end-user personnel, and fraud under the Exchange Act and the CEA	Lehman Brothers	Ongoing.
7	UNIPEC	\$44	Currency swaps	Fraud, breach of fiduciary duty, transaction conducted with unauthorized end-user personnel, and fraud under the Exchange Act and the CEA	Lehman Brothers	The parties settled for an undisclosed amount.
8	Selta	\$30	Interest rate and currency swaps	Misrepresentation, breach of fiduciary duty, negligence, and breach of contract	Salomon Brothers	Ongoing.

No.	Entity or individual reporting losses	Loss amount (millions) ^a	Specific type of derivative product	Relevant lawsuit claims, defenses, or counterclaims	Dealer	Outcome of lawsuit
9	Laszlo Tauber	\$26	Currency swaps, forwards, and options	Fraud, breach of fiduciary duty, violations of state bucketing and gambling laws, and transactions in dispute were illegal off-exchange futures and options under the CEA	Salomon Brothers	In a ruling later affirmed by the Fourth Circuit Court, the U.S. District Court for the Eastern District of Virginia rejected all of Tauber's state-based defenses and counterclaims. In addition, the court concluded that the disputed transactions were exempt from the CEA and thereby rejected all of the counterclaims asserting that the dealer had violated the CEA.
10	Gibson Greetings, Inc.	\$21	Interest rate swaps and options	Fraudulent concealment, breach of fiduciary duty, reckless and negligent misrepresentation, and violations of the CEA's general fraud section (4b) and fraud by a commodities trading advisor (4c)	Bankers Trust	The parties settled, with Bankers Trust forgiving \$14 million of the \$21 million owed to it by Gibson Greetings.
11	Sinochem	\$20	Interest rate swaps	Transaction conducted with unauthorized end-user personnel	Lehman Brothers	The parties settled for an undisclosed amount.
12	PT Admitra Rayapratama	\$16	Interest rate swaps	Breach of fiduciary duty, professional negligence, negligent misrepresentation, violation of the CEA commodities trading advisor fraud section (4c), and violation of the Racketeer Influenced and Corrupt Organizations Act (RICO)	Bankers Trust	The U.S. District Court for the Southern District of New York dismissed the federal commodities and RICO claims because they were precluded by the parties' contractual choice of the law of England. The court also dismissed the common law claims that remained because the dismissal of the federal law claims removed its jurisdiction over those claims. The parties subsequently settled for an undisclosed amount.

No.	Entity or individual reporting losses	Loss amount (millions) ^a	Specific type of derivative product	Relevant lawsuit claims, defenses, or counterclaims	Dealer	Outcome of lawsuit
13	Equity Group Holdings	\$11	Interest rate (bond) options	Negligent misrepresentation and breach of fiduciary duty	Bankers Trust	The parties settled for an undisclosed amount.

^aThe loss amounts reported may include realized losses, unrealized losses, losses arising in part from products or activities other than OTC derivatives, or the amount of the loss may be in dispute.

Sources: Court documents, journal articles, press accounts, and interviews with dealer officials.

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