The Snake and the Tail
Theory of Derivatives’ Regulation and the Asymmetry of the Global Financial Crisis

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Abstract

The article concentrates on empirical verification of three competitive theories of the evolution of financial law, namely: the “origin of law” hypothesis, the “incompleteness of law” theory and the “normative uncertainty” hypothesis. It examines the adequacy of these regulatory approaches and their relative merits within the light of the asymmetry of the present financial crisis.

A. Introduction

The asymmetry claim will be based on the comparison of two different applications of derivative instruments under various regulatory regimes. The paramount role played by the credit default swaps (CDS) in the financial crisis in the US will thus be contrasted with the so-called “Polish toxic currency options crisis”. In both cases the rapid expansion of financial instruments (CDS in the US and vanilla currency put options in Poland) had been anticipated by regulatory failures. Nevertheless both the causes and the effects of the regulatory failures were extremely different. These facts beg the question whether or under what circumstances the internationally (G20, Basle Committee) or regionally (EU) coordinated regulatory response could be both applicable and successful in terms of its influence upon diversified and fragmented financial markets. The second part of the paper will concentrate on the notion of evolution of law as a process induced by the change of economic theory within the light of policy recommendations concerning derivatives and in a broader sense the speculation as a kind of market activity.

The brief look at the American deregulatory reform (Commodities Futures Modernization Act 2000) justifies some scepticism towards any theory of linear legal evolution, especially in a form of the “incomplete law theory”. Additionally, the dynamic growth of financial innovation does not facilitate the regulatory task. The question remains how to combine innovation with security under the conditions of uncertainty (the normative uncertainty hypothesis). In this respect the recent financial law legislation in the UK (2000), the EU (2006), Germany (2007), Poland (2008) and France (2009) will finally be contrasted with the alleged purposes of the future US regulation of the OTC derivatives. It seems that under the “normative uncertainty” any valuable theory of derivatives’ regulation should promote “dynamic efficiency” and flexibility rather than fixed regulatory approach, con-
centrated on one particular purpose. Thus the future regulatory frameworks will have to be responsive and multi-purposive.

B. Three Models of Derivatives Regulation

According to the ‘legal origin’ theory, legal institutions developed within the common law legal systems create better conditions for the protection of shareholder’s interests in comparison with the civil law systems. Concurringly, companies in the common law systems could have developed much faster, having better access to financial resources. Sometimes the legal origin hypothesis is being elaborated further, to contain two substantial claims: the “law matters” claim and the “legal origins” claim. According to the “law matters” claim, legal rules create the institutional framework for market economy, establishing property rights and enforcing contracts. Legal rules and their enforcement by the state could thus indirectly influence the economic output attracting investors by safeguarding their potential returns.

Therefore the quality of regulation plays an important economic role, even if transaction costs are relatively low. Additionally, the “legal origins” claim states that the quality of laws varies depending on whether that legal

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system belongs to the common law or to the civil law legal family. Common law is said to establish legal rules which would be superior in terms of shareholders protection and thus creating better conditions for rapid growth of firms. The reason for that contention is not clear, although it is generally claimed that common law as judge-made law is more flexible and can be adapted to changing circumstances. It is also claimed that judicial independence creates a very good safeguard against the anomalies of political process that often penetrate the statutory law-making process. The anomalies of the law-making process are supposed to influence civil law systems, leading to wasteful legislative results due to the influence of interest groups. Additionally, civil law is said to be more ‘rigid’. The question remains whether the same could be said about the differences between civil law and common law regulatory regimes on derivatives.

It can only be said that a brief sketch of the evolution of anti-speculative laws proves the opposite, the main vehicle of change being statutory law and the common law often being even an obstacle towards liberalization. Moreover, there is no evidence that the civil law jurisdictions adopted significantly different attitudes towards derivatives. The difference lies rather in the style of regulation and the institutional regime. In Germany the general legislation was enforced for a long time directly by the courts. The same could be said about France and the UK in the nineteenth and the first half of twentieth century. Moreover, there was virtually no difference of the scope of regulation. All anti-speculative laws established in the second half of the nineteenth century were essentially similar, reflecting the same attitude towards speculation: the general enforceability of contracts for differences was balanced with exemption clauses concerning organized stock exchanges. Thus the presently called over-the-counter (OTC) derivatives became unenforceable.


In this context one may examine the question: either the liberalization of the derivative market is inefficient from the economic standpoint or judge-made law falls short in terms of flexibility and production of economically efficient rules. Assuming that the evolution of derivative market is efficient and that the financial innovations meet important economic needs such as the increase of fluidity, spread of information and dispersing risk, it seems that the law’s origin hypothesis does not work in the context of derivative regulation. Moreover, the differences between the American and British approaches and regulatory techniques create a source of puzzlement for the potential adherents of the law’s origin hypothesis. It is not clear to what extent the law’s origin matters since both systems finally arrive at very different conclusions, adopting strikingly different regulatory regimes. Moreover, the discrepancy between the American and English regulatory approach is additionally paired with the significant similarity between the English, French and German regulations. In all of these European jurisdictions the regulatory framework seems to be at least analogical, if not the same.

Nevertheless, it may be beneficial to assume that this evidence is not conclusive and that the American approach finally favored the most efficient regulatory regime. This could be possible under the assumption that the economic theory regards derivatives as instruments with the power of putting the market in jeopardy. Therefore, even though it had been true, the restrictive regulatory approach should be flexible enough to react to the evolution of the economic theory pertaining to the economic function of derivatives. Meanwhile, it should be stressed that the basic framework of the American derivative regulation remained virtually untouched for almost one hundred years. It seems however that the difference between American-style and European-style regulation is conceptually too broad to be useful. Still, the regulatory regime seems to respond to the economic proviso at least to some extent.

The major weaknesses of the origin of law theory such as its institutional asymmetry and its strong dependence upon the overstated differences

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between civil law and common law could possibly be overcome. This seems to be the case of the incomplete law hypothesis. The incomplete law theory does not build on the strict distinction between the legal families, concentrating rather on the type of institutional arrangements, and therefore it seems to be a much more promising candidate for the positive theory of the regulation of derivatives. The fundamental assumption purported by K. Pistor and Ch. Xu is that firstly, law is in general inherently incomplete and secondly, that the incomplete system cannot be effectively enforced. The power to interpret existing law, to adapt it to changing circumstances and to extend its application to new cases could thus be called ‘residual law-making power’. According to the “incompleteness of law” theory, residual law-making powers may be conferred to the legislature, courts, or regulators. Hence, depending on the identity of the residual law-maker, the regulatory regime could be legislator-oriented, judicially-oriented or administrative-oriented.

While analyzing the development of financial law between the nineteenth and twentieth century, the authors come to the conclusion that the legal evolution leads from the judicially- or legislator-oriented regulatory frameworks to the more developed forms in which the administrative agencies have the last say. This hypothesis is illustrated by the parallel development of the English, American and German financial law, leading in all jurisdictions towards the paramount influence of specialized administrative agencies, playing the crucial dual role of residual law-makers and ultimate enforcing agencies at the same time. Both common law systems with the paramount role of judge-made law and civil law countries, where the statu-


\[13\] K. Pistor & Ch. Xu, supra note 10, 933-934.

\[14\] Id., 934.

\[15\] Id., 963.

\[16\] Id., 1010-1013.
tory enactments responded to the problem of incomplete law, tend to develop the specialized agencies.

It has been suggested that the regulatory powers of either private or public regulatory agents developed faster in common law jurisdictions such as the US and the UK than in Germany\(^{17}\). This could be an effect of both faster development of financial markets and relatively greater incompleteness of law in those countries. It seems that even if the incompleteness of law theory applies to the financial regulations concerning stock market and shareholder capital, for various reasons it is not necessarily an adequate instrument to be used within the development of derivatives. Firstly, it does not capture the fundamental difference between the stock exchange traded derivatives and the OTC derivatives\(^{18}\). Secondly, the smooth evolution from judge-made or statutory rules to the sophisticated regulatory frameworks administered by specialized regulatory agencies is questionable. There are two reasons for this criticism: firstly, there is no integrated regulatory regime for all derivative instruments in the majority of jurisdictions, the regulation being based on a patchwork of security regulators, stock exchange supervision, and judicial enforcement in case of the OTC contracts; the existence of one integrated regulator and supervisor being nothing more than a political and regulatory challenge or mere wishful thinking. This line of reasoning is albeit not conclusive. It surely undermines the positive claim while leaving the normative claim untouched. Analytically, it could be possible that the derivative market as a whole has not yet reached the stage already attained by the regulation on financial securities.

Thus the question remains as to how to combine innovation with security under the conditions of uncertainty. This fundamental regulatory consideration is reflected by the normative uncertainty theory\(^{19}\). Therefore, the normative theory of regulation would favor the capability to adapt the regulation to changing circumstances rather than a fixed regulatory approach, concentrated on one particular purpose. Such an approach is very often


\(^{19}\) M. J. Golecki, ‘Titanic, albo wstęp do neokapitalizmu’ (‘Titanic or the Introduction to Neocapitalism’), 1 Praktyka Polityczna (The Political Practice) (2004), 106-118.
called reflexive regulation. Not intending to define reflexive regulation or a wider concept of reflexive governance, it is still important that it is oriented on the maximization of dynamic efficiency, as juxtaposed with mere static allocative efficiency. The reflexive regulation could also be associated with the I. Ayres’ and J. Braithwaite’s theory of responsive regulation and the so-called Australian theory of regulation. The main point is that the reflexive or responsive regulation should be based on a flexible regulatory framework, which means inter alia that it should be based on principles rather than on rules.

The difference between rules and principles could be expressed in various ways. Within the context of the theory of regulation perhaps the most significant difference concerns much higher degree of flexibility and openness of principles in comparison with the relatively well entrenched and precise rules. Thus the major features of reflexive regulation are the predominance of the purpose-oriented rules and principles, a vast scope of discretionary powers, the hierarchy of legal remedies in a form of the so-called pyramid of sanctions and the dialogical-discursive approach, as the regulator collects data and transforms private information revealed within the process of regulation into the public one.

The last feature of the responsive regulation, namely the discursive process of adaptation and dialogical character of the regulator-agent interactions, is sometimes described in terms of a bargain taking place between the regulatory agency and the operating business enterprise. This contractual aspect of the relation plays an important role in regulatory endeavor, since the regulator, due to the constant monitoring and dialogue with the regulated subjects, could obtain the relevant private information possessed by the business entities. The information centered strategy reflects the fact that the access to the relevant private information on derivative strategies, tech-

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niques, methods and relevant practices is otherwise difficult to collect and prohibitively costly. The communication between the regulator and entrepreneurs plays an important if not crucial role, according to the contemporary network-oriented theories of regulation\textsuperscript{24}.

Nevertheless, the acceptance of the responsive regulation in a style proposed by I. Ayres and J. Braithwaite raises some well known problems. One of the most serious issues is the fact that it is not clear how the regulator could sustain the cooperation with the agents whose activities are being regulated, thus being the subject of constraints\textsuperscript{25}. Certainly, the principle-based regulation is always affected by the limited scope of accountability of regulatory bodies. Sometimes it is even suggested that the responsive regulation contradicts basic constitutional principles, such as proportionality principle, leading to the illegitimate interference of public bodies with the potential economic actions of private agents, who are unable to predict the potential strategy, purposes and actions of regulators\textsuperscript{26}. These observations even if valuable, seem to be far-fetched, given the fact that the actions of regulators are not deprived of substantial control of legality. The judicial control of administrative actions seems to be the best way of combining the regulatory efficiency with the requirement of the rule of law and constitutional accountability. Additionally, the division of power and tasks between the regulators and the courts seem to be a constant point of reference for any feasible and realistic theory of regulation\textsuperscript{27}.

C. The American Credit Default Swaps Case

The very short story of the US derivatives regulatory framework reads as follows: In the beginning was the word, or concept, called “unrestricted freedom of contract”. This lasted until the middle twenties of the XX century. Later on the massive regulation made the world better off, for the financial world has been dramatically tortured by the glooms of great depression.

\textsuperscript{24} For the characteristics of the institutional theories of regulation, in both, information based and network oriented forms cf. B. Morgan \& K. Yeung (eds), \textit{An Introduction to Law and Regulation} (2007), 53-79.
\textsuperscript{26} \textit{Id.}, 167-170.
\textsuperscript{27} J. Black, \textit{Rules and Regulators} (1997), 33.
The whole structure of federal agencies has been established as the offspring of the New Deal policy. The regulatory powers over derivatives have been divided between the Stock Exchange Commission and the Commodity Future Commission. Those agencies regulated, supervised and enforced restrictive anti-speculative laws; then the trend to liberalization came in the 1970’s, derivatives still being generally regulated by the Commodities Exchange Act (CEA) with the growing list of exemptions issued by the Commodity Futures Trading Commission (CFTC). In general, all ‘contracts for future delivery’ were either exchange-traded or void. Thus the OTC market existed only within the scope of the CFTC exemptions, concerning basic OTC transactions.

Such a regulatory framework lasted until the year 2000, when the US congress passed the Commodity Futures Modernization Act 2000 (CFMA) deregulating OTC derivatives by virtue of exemption from the application of CEA and the regulatory power of the CFTC. According to Section 2(d)(1) of the CFMA 2000, parties who are “eligible contract participants” (ECP) to any individually negotiated derivative contract on any commodity are excluded from the application of the CEA. Moreover, Section 2(d)(2) stipulates that the CEA is generally not applicable at all to those transactions. The only exception to that rule is the set of provisions concerning fraud and manipulation of market price, which means that the scope of regulation is limited to fraud and price manipulation. Thus the statutory law provided for deregulation, and ousted the jurisdiction of existing agencies. At the same time such a deregulated approach created some doubts concerning the existence of any regulatory framework for the OTC derivatives.

The underlying assumption might have been that the very statutes of the “eligible contract participants” would create a sufficient regulatory safeguard, since the requirement for ECP’s would have selected only the sophisticated professional market participants (US financial institutions, non-US regulated insurance companies and banks and their US branches and agencies, participants acting as brokers, agents, investment advisers or fiduciaries) and natural persons with more than USD 5,000,000 in assets who enter into the related transactions for risk management purposes. In effect, the CFMA acted as a double sword: it either excluded some market participants from any supervisory regime as in case of eligible natural persons or shifted

that task to other agencies, already supervising some categories of financial institutions.

The move to fragmentation and decentralization of supervision may be regarded as striking phenomenon if compared to the British FSMA 2000, which adopted the opposite approach, creating a single integrating supervising agency, i.e. FSA. This alteration of the regulatory structure has provided with an excellent opportunity for the regulatory failure. The lack of any control on the so-called over the counter derivatives led to the rise of systemic risk and finally resulted with a spectacular threat to the whole banking and financial system.

Within this context of particular interest are credit default swaps. Those instruments were contracts concluded by the parties on unregulated market. A CDS contract is typically privately regulated according to the confirmation published by the International Swaps and Derivatives Association (ISDA), which concerns the credit derivatives definitions and basic terms of typical credit derivatives contracts. According to some judicial decisions swap based derivatives are to be treated as contracts and not as securities, as it had been stated in Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270 (S.D. Ohio 1996). Moreover, the judgment in Caiola v. Citibank, 137 F. Supp. 2d 362, 364-65 (S.D.N.Y. Apr. 2, 2001) had impact on the evaluation of the legal status of the so-called soft law regulations issued by International Swap and Derivatives Association for the OTC derivative transactions. The court held that certain provisions of the ISDA Master Agreement could have prevailed over the statutory provisions of the Securities Exchange Act 1933 (SEA).

Against this background it seems that courts in fact acted as residual law-makers, creating a basic legal framework for CDS. The question remains whether that framework was an adequate legislative tool. In order to evaluate the deregulation and heavy dependence on the ISDA style soft law, a closer look at the dynamic of the market for the OTC credit derivatives is needed. Firstly, the financial mechanism and the economic purpose of the CDS should be identified. Accordingly a credit default swap (CDS) can be described as a credit derivative based on a relatively simple mechanism. One party makes periodic payments to the other, and in return he or she receives a payoff in case of default concerning the so-called underlying instrument. If the later party actually owns a debt, the CDS can constitute a kind of insurance against the risk of default. This especially concerned a secured debt, very often somehow related with the market for immovables. Generally such a situation is regarded as hedging. However the party may enter into the CDS contract without owning any debt for reason of clear
speculation. Such a “buyer” of the CDS simply bets against the solvency of the debtor in a gamble to make money if it fails.

If the relevant debtor defaults, there are two possible solutions. Firstly, the party which holds a debt delivers a defaulted asset to the counterparty for a payment of amount of money, which is usually called physical settlement. Secondly, the counterparty pays the difference between the par value and the market price of a specified debt obligation, which is termed cash settlement. Since 2003 CDSs started to be used rather by the speculating parties than by banks willing to insure against default. Thus the CDS has been transformed from the hedging based instrument into the highly speculative contract for differences, which in fact constituted a kind of bet for or against the likelihood that a particular company would suffer financial difficulties and default to pay debt.

The above situation cumulated both systemic risk and liquidity risk. Consequently, the market for CDS grew, and in 2007 it reached the peak notional value of USD 45 billion. In 2008 the CDS market collapsed after a number of spectacular events such as the collapse of Bear Stearns and its taking over by JP Morgan in March 2008 and the bankruptcy of Lehman Brothers. The latter meant that approximately USD 7 billion eventually had to be paid to the buyers of CDS protection issued against the default undertaken by that bank. Additionally in September 2008 American International Group (AIG) required a federal subsidizing because it had been excessively selling CDS protection without hedging against the possibility of default. Those events eventually threatened the stability of the whole banking and financial system leading directly to the global financial crisis.

The reasons of the American financial crisis of 2008 are certainly complex. However it is obvious that some sophisticated derivative instruments significantly contributed to the systemic nature of the failure of the whole financial system. Two major considerations loom large on the horizon. Firstly, the adopted deregulatory policy deprived the system of any monitoring system. This is particularly evident in case of the unexpected risk exposure and inability to control it. Additionally, the system has been significantly weakened by the introduction of a patchwork of fragmented private clearing houses, which were unable to minimize the legal risk of non-performance. This finally led to cumulated bankruptcies and further eroded the system as a whole. According to the sec. 2 d 1 of the CFMA 2000, CDS

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30 According to the ISDA Market Survey, Year-End 2008.
have become exempted from regulation by the SEC and the CFTC, as any other OTC derivatives, provided they had been issued by the ECP.

In case of the over the counter CDS market this led to the unexpected increase in both legal and systemic risks. The legal risk stem from the fact that the CDSs where not standardized. The ISDA documentation requirements played an important albeit primarily procedural role. The substantial elements would concern method of calculating the relevant payout. The increasing complexity of the methods of calculation empowered by the gradual departure from the underlying instruments rationale brought about a considerable level of uncertainty leading to the increase of the other party risk and finally to the risk of default. This especially pertains to the so-called ‘vanilla CDS’, where the underlying protection is sold as a broad category of "Bond or Loan" instead of being sold on the reference entity which is the underlying debt.

The main outlines of the presently proposed regulatory reform concentrate on the potential harmonization and standardization of the CDS contracts. This certainly leads to the question whether the stock exchange would not be the best institutionalized safeguard of that standardization. Additionally, a stock exchange secures not only standardization but also volatility and enforcement by the clearing house. A clearinghouse operates as a kind of buyer to any potential seller and as a seller to every buyer. This mechanism significantly reduces the risk of a counterparty’s breach of derivative contract, whereas in case of the OTC market, participants are exposed to each other’s default risk, which usually is referred to as to the counterparty’s risk.

The lack of centralized enforcement system in a form of clearing house became the major cause for the increase of systemic risk. The problem has at least partially been initiated by the defragmentation and privatization resulting from the CFMA 2000. The Act has led to the creation of ineffective network of private clearing houses which has not been up to the task in crucial moments. As has been announced by the US Secretary of the Treasury, Timothy F. Geithner, the awaited American regulation of derivatives should fulfill the following expectations and purposes: “(1) preventing activities in those markets from posing risk to the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that
OTC derivatives are not marketed inappropriately to unsophisticated parties."

D. The Polish Toxic Currency Options Case

The lack of standardization of derivative contracts and centralized clearing house systems should not be treated as an exclusive problem of the OTC derivative market. During the 2008-2009 financial crisis different markets have been affected by various types of market failures. In the US the deregulatory policy on OTC derivatives has resulted in over-exposure towards risk and created very good conditions for excessive speculation with credit derivatives (especially credit default swaps-CDS), leading to liquidity problems and gradually affecting the whole banking and financial market. Additionally, the crisis had an immense impact on other markets, where the toxic financial instruments such as the CDS-styled derivatives and collateralized debt obligations (CDOs) have not even been traded.

Against that background the case of the Polish currency toxic options could be presented. Since 2008 over 10,000 Polish companies engaged in contracts designed to protect them from a stronger Polish currency złoty. The main economic reason for this strategy was the fact that the value of the euros they earned from selling goods and services in Europe had continuously been decreasing for last consecutive 5 years. However, the unexpected collapse of the Polish currency has had very serious financial and economic consequences leading to many prospective bankruptcies. The Polish Financial Supervision Authority (PFSA) estimated that at least 99 Warsaw Stock Exchange-listed companies concluded option deals in 2008. Many relatively small private firms have been exposed as well. The currency has lost nearly 30% of its value against the euro between October 2008 and March 2009. About 1500 firms may go bankrupt in case of performance of the option currency contracts. The aggregated loss of Polish exporters amounted to 18 billion PLN (approximately €5 billion).

32 Komunikat KNF z dnia 17 grudnia 2008 r. w sprawie wpływu walutowych instrumentów pochodnych na banki i spółki publiczne, (The Announcement of the Polish Financial Supervision Authority of the 17 of December 2008, On the impact of derivatives on banks and public limited companies (2009), 1-4.
33 Based on The Announcement of the Polish Financial Supervision Authority of the 11 of March 2009, Note on exposure of Polish companies to FX derivatives: “Banks”
Both macro and micro effects are discernible. On the macro level the rise of unemployment and bankruptcy of so many enterprises, massive loss of the bigger, including the biggest, stock exchange listed companies, will have a considerable impact on the whole national economy. On the micro level the prospects of relationship between banks and investors are not clear since many banks had allegedly acted as financial advisors, thus breaching their fiduciary duties and enticing small firms to conclude the toxic derivative transactions, especially toxic currency options, where the banks in fact hedged against the decline of the Polish currency\textsuperscript{34}. The information on risk exposure had not been properly disclosed. Moreover, many contracts notoriously contained some hidden provisions or suffered other serious formal defects. Dissatisfied firms claimed not only misrepresentation, but also more serious defects such as deceit and fraud accompanied by breach of fiduciary duties by banks’ representatives.

Under those conditions two issues should be addressed. Firstly, the question arises whether the case of Polish toxic currency options is a market or government failure. Secondly, under the assumption that there was a real market failure, how should the government and the judiciary respond to the potentially disastrous economic consequences of those contracts for a group of business entities? As to the first question, there seems to be no unanimously accepted answer. Thus, each contract should be scrutinized on an individual basis. This requires control performed by the courts. In fact, the majority of loss-suffering disappointed companies have brought claims against banks, submitting for resolution or invalidation of those option contracts. One of the possible solutions is to adopt the position, that those contracts as bets or contracts for differences were valid but not enforceable.

There is no straightforward solution on the level of national contract law, regulated by the Polish Civil Code\textsuperscript{35}. The other option may still be contemplated, namely the general legislation rendering the majority if not all option contracts void or voidable.

presettlement exposure estimated as MTM value amounted to around PLN 9 bn in case of FX options (c.a. 52 per cent of total exposure), over PLN 7 bn in case of FX forwards (c.a. 38 per cent of total exposure) and around PLN 2 bn in case of FX swaps and CCIRS (c.a. 10 per cent of total exposure). Euro is an underlying currency for 77 per cent of total exposure (based on MTM value) and US dollar constitutes c.a. 14 per cent respectively”, available at: http://www.knf.gov.pl/Images/Instrumenty_pochodne_komunikat_ENG_a_tcm20-9929.pdf (last visited 31 August 2009).

\textsuperscript{34} P. Karkowski, \textit{Toksyczne opcje - od zaufania do bankructwa ("Toxic Options - from Trust to Bankruptcy")} (2009), 231.

\textsuperscript{35} \textit{Id.}, 198.
depending on the version of the bill. Three bill proposals have been prepared so far but there is no political consensus as to which one of them should be implemented.

This is not however, the complete milieu of the case, as the European Union’s normative influence should also be taken into account. Poland is a member of the EU since May 2004. In 2006 the European Council adopted the EU’s Markets in Financial Instruments Directive (MiFID), stipulating minimum requirements for the protection of individual unsophisticated investors. The implementation of the directive would have solved the problem of toxic options provided the contracts where fraudulent or unbalanced. In other terms, if the option contracts had constituted a typical case of market failure, the problem would have been solved by the implementation of the directive. The Polish government failed to adopt the directive however, thus acting in breach of the EC law.

As a summary it could be stated that the Polish toxic options case resulted from lack of consumer protection and in the existence of the political bias which prevented the implementation of the EU MiFID 2006 directive. Thus, the relatively cheap protection in a form of the already enacted EU directive has not been deployed. It could be said that the Polish government eventually failed both to prevent the spread of the toxic derivatives and to regulate the market ex post. In fact the government and the legislature decided to shift the burden of regulatory task to the court. It seems however obvious that the implementation of the MiFID was in fact a much better option than conferring the role of the interstitial legislator to the ordinary courts. The solution which finally has been adopted seems both exuberant in term of costs and unsatisfactory, since the MiFID directive has still to be implemented by the Polish government. Thus the Polish toxic options case seems to be a good example of inefficient deployment of courts as residual law-makers.

Meanwhile the differences between the US and Polish derivative crises are striking. Both the Polish and the US financial crisis stemmed from the lack of regulation, but the nature of the process was different. In case of the US market for CDS’s the fragmentation and deregulation led on the one hand to the financial crisis, on the other hand to the serious development of financial instruments. It is true that the regulator not only did not emerge, but the already existing CFTC has been incapacitated by the expensive legislative intervention. However this incapacitation resulted at least in the unexpected growth of derivative market for CDS. In Poland, the costs of the regulatory failure are not balanced by any serious development in deriva-
The financial instruments such as vanilla currency options have been widely applied for at least ten years. The significant difference lies in the fact that the American OTC market for CDSs cannot be based on the judicial enforcement, for that would result with major break down of the financial liquidity. Courts are simply not fast enough at that stage of the financial market development. If this is true, then the development of the financial market should lead to the prospective centralization. The growth of the quasi stock exchanges in derivatives and finally the diminishment of the role of OTC markets would become possible albeit unintended result of the financial crisis. In other terms the present financial crisis seems to be just nothing more than a price or cost which would inevitably accompany such a regulatory and institutional shift.

E. Conclusion

Three different models of regulation are discernible as a regulatory and evolutionary response to the potential risks related to financial innovation, namely transaction-oriented, institution-oriented and market-oriented model. It seems that the market-oriented model of regulation has not accidentally been adopted by many jurisdictions. Taking the unusual and diversified evolution of derivatives market into account, two lessons should be remembered. Firstly, the financial crisis proved that regulation is necessary and good regulation requires a sound normative theory of both derivatives and investors’ behavior. Additionally, it seems that the judicial regulatory capacity could still play an important albeit limited role among the regulatory instruments and institutional arrangements. Thus the judicial governance remains a significant alternative to market and political processes, whereas in majority of cases the regulatory framework seems to depend primarily on the quality of regulators, especially public agencies. At the same time the output of the flexible regulatory process should remain under the control of judges so that the principle of rule of law is safeguarded. Thus the quality of regulation will in the future depend on the division of labor between courts and regulators. There is however no universally applicable regulatory strategy, since the heterogeneity of financial markets and the diversity of regulatory approaches remain untouched.