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**Book Review**

## Book Review: Capital markets, derivatives and the law

Aussenwirtschaft

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**Alan N. Rechtschaffen (2009):**

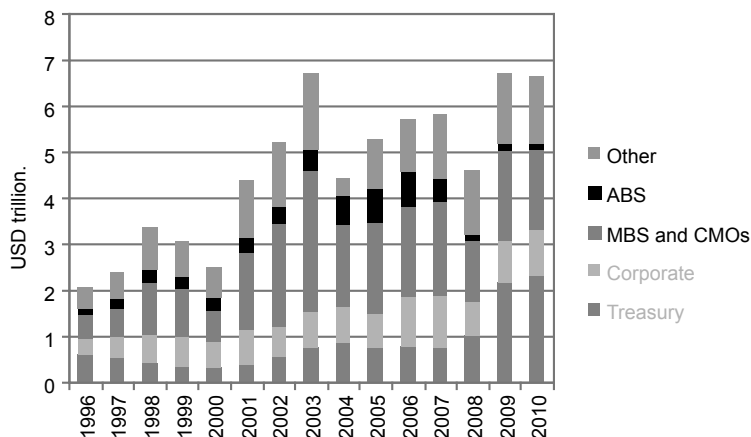
**1 Capital markets, derivatives and the law**

Oxford University Press, New York, 384 pages (hardback)

ISBN13: 9780195339086; ISBN10: 0195339088; USD 247.50

Since the 1990s the issuance of financial instruments has rapidly increased. This rise was caused mostly by the rapid expansion of complex debt securities and derivatives created through securitization of housing loans (see Figure 1 for an example of the US bond market). The explosion of the crisis on the US market for subprime loans, as well as its rapid transmission to other financial markets, proved, that the nature of these instruments and risks involved with their issuance and holding were commonly misunderstood. The complex legal form of these instruments often efficiently hid their economic substance. Hence, there is a need for better education of all parties involved in transactions on financial markets and analysis of such transactions. This includes also the attorneys, who have a legal and ethical obligation to understand the financial concepts that underlie the transactions on which they are working. This educational gap could be partly fulfilled by the book “Capital markets, derivatives and the law” by ALAN N. RECHTSCHAFFEN.

**Figure 1:** Bond issuance in the USA



*Source:* Own calculations based on SIMFA data, <http://www.simfa.org>

The primary goal of the book, as Mr RECHTSCHAFFEN describes it in the Introduction, is to make “the reader comfortable with the basics of capital market trading activities” and “to demonstrate the basic knowledge necessary to weather financial storms, providing the knowledge necessary to understand this and future financial crises and to participate in the capital markets”. The author is a renowned academic, recently associated with the New York University School of Law and the Fordham University School of Law. He specializes in risk management and regulation of capital markets. He also held numerous positions in public administration and business. While writing this book, he drew on his experience as a lecturer and advisor, as well as on research of his students in the areas derivatives, risk management and financial instruments.<sup>1</sup>

<sup>1</sup> See the acknowledgments section of the reviewed book.

The book is composed of 16 chapters, foreword by Dr. Susan Phillips,<sup>2</sup> preface, introduction and an appendix on the design and implementation of the Supervisory Capital Assessment Program.<sup>3</sup> According to their contents, the chapters could be roughly divided into four subsets: general issues regarding financial markets and instruments (1–3, 5–6 and 12), legal regulations of financial instruments (4, 11 and 13–14), types of debt securities (7–8) and types of derivatives (9–10 and 15–16). The contents of each chapter will be summarized in the next paragraphs according to this division.

Let us begin with the chapters on general issues. The first chapter describes the origins and evolution of the recent US financial crisis, as well as the actions of the federal government and the Fed to ease liquidity strains and support the slowing economy and weakening companies. It is followed by a chapter introducing to basic concepts of financial markets and instruments (primary vs. secondary markets, debt vs. equity etc.) and to the role of an attorney in the context of financial instruments' issuance and trading. In the next chapter the motivations for issuing and holding financial instruments are discussed, with a focus on hedging risk and enhancing return (speculation). The fifth chapter is devoted to explaining the role of interest rates (especially the federal funds rate) in the economy and to the responsibilities of the Federal Open Markets Committee. A chapter on asset valuation follows, with a focus on interest rate yield curves. Finally, in chapter 12 the principles of risk management process (consisting of identification, assessment, monitoring and control/mitigation of risk) are discussed.

We shall now review the chapters dealing with the US legal regulations of financial instruments. The fourth chapter encompasses the basics of securities regulation (beginning with the Securities Act of 1933 and the Securities Exchange Act of 1934). It also describes elementary characteristics of financial market regulators (Securities and Exchange Commission, Commodity Futures Trading Commission) in the United States. Special attention is given to the statutory definitions of securities and to legal tests that allow to determine whether a financial instrument is a security and hence whether it underlies state and federal regulations on securities. Regulations of derivative transactions are discussed in chapter 11, as well as the institutional structure of exchanges and regulatory agencies. Chapter 13 describes some litigation issues in the context of financial instruments, that could arise from violation of federal or state laws on securities or common law theories, as well as from non-compliance with self-regulation standards. Some attention is devoted to litigation issues regarding particular kinds of derivatives. Finally, the following chapter is devoted to the problem of suitability of financial instruments for different types of clients, especially retail investors and other unsophisticated entities, and to consumer protection in financial markets.<sup>4</sup>

Types and characteristics of debt instruments issued by the US Treasury Department are described in the seventh chapter, and issued by other entities (corporations, municipalities and federal agencies) – in chapter 8. In chapter 7 there is an additional focus on the so-called risk-free nature of government securities and on the auction facilities, in which these securities are distributed. In chapter 8 the role of rating agencies is also discussed.

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2 Dean of the George Washington University School of Business, former member of Fed's Board of Governors and former Chairman of the CFTC.

3 SCAP was a stress-testing exercise designed by the US supervisory authorities for bank holding companies to measure their capital needs in case of materialization of an adverse economic scenario.

4 In the European Union suitability matters are regulated by the Markets in Financial Instruments Directive (MiFID).

Let us finally move to the chapters concerning derivatives. The ninth chapter contains the definition of derivatives and their classification into forwards, futures, options and swaps. The next chapter is focused on chosen types of swap transactions – vanilla swaps, currency swaps and credit default swaps. In chapter 15 types of options and option strategies are presented, as well as the basic Black-Scholes model for option pricing. The last chapter is devoted to structured financial instruments, such as hybrid securities.

As the author himself states it in the Introduction, the outline and methodology of the book is unique. The text has a strong focus on practical problems concerning financial instruments and their trade. A distinctive positive feature of the book is the extensive usage and description of judicial rulings regarding the analysed matter, that allow to better comprehend often complicated issues (some examples were given in previous paragraphs). In order to better acquaint the reader with the topic, there are numerous quotations from officials' speeches (especially from the previous and current US administration and Federal Reserve Board) and samples of official documents (for example FOMC minutes, p. 109). The text is generally well written and even a reader unfamiliar with the details of the US legal system and financial markets can easily follow the lecture. Last but not least, the book features a comprehensive index, that helps to better navigate through its contents.

Although the reading matter gives a generally positive impression, there are some drawbacks that could hinder the understanding of the otherwise clear argument. Most important of these will be shortly discussed in the following paragraphs.

First of all, in a book on capital markets one would expect numerous data quotations, graphs and tables to illustrate and support the reasoning; yet, numerical evidence accompanying the text is scarce. Sources of data on financial institutions and instruments are rich and easily accessible, especially in the USA. It would be advisable to tap them in order to give the reader a more complete picture of the matter (an example would be the structure of bond issuance presented in figure 1).

What is more, some financial and economic terms are used imprecisely. To quote some examples: firstly, "duration" stands as an equivalent of "time to maturity" (p.125), even though in the financial dictionary there is a distinct difference between the terms.<sup>5</sup> Secondly, referring (p. 123–124) the seminal papers on portfolio theory by inter alia MARKOVITZ and SHARPE,<sup>6</sup> the author states that "a rational investor seeks to minimize risk while maximizing reward"; however, portfolio theory assumes that these two objectives are contradictory and it is impossible to follow them simultaneously. Hence, "a rational investor" chooses either a portfolio with maximum profitability given the maximum risk level he is willing to take, or a portfolio with a minimum risk level out of those that satisfy his minimum profitability expectation.<sup>7</sup> Thirdly, quoting the historical range (maximum and minimum) of prices as an example of volatility measures in the context of option pricing is an oversim-

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5 Generally speaking, duration can be described as effective maturity or a measure of not only time to maturity, but also interest rate risk of an instrument. For a comprehensive definition and calculation of duration see for instance: F. S. MISHKIN, S. G. EAKINS, *Financial Markets and Institutions*, Sixth Edition, Pearson International Edition 2009, p. 61 and further.

6 H. MARKOVITZ, *Portfolio Selection*, "Journal of Finance" Vol. 7, No. 1 (March 1952), pp. 77–91; W. F. SHARPE, *Capital Asset Prices: a Theory of Market Equilibrium under Conditions of Risk*, "Journal of Finance" Vol. 19, No. 3 (September 1964), pp. 425–442.

7 Ibidem.

plification that could potentially be misleading.<sup>8</sup> While range is a basic measure of diversity, it would be much more helpful to introduce the concept of standard deviation or variation coefficient.

Finally, it seems that the contents of the chapter on asset valuation (sixth) is insufficient. A reader, especially an inexperienced one, would certainly benefit from a more thorough examination of the relation between interest rate changes and the value of different financial instruments. It would also be advantageous to shortly introduce the two basic valuation approaches, that is fair value and amortised cost using effective interest method.<sup>9</sup>

To sum up, the book “Capital markets, derivatives and the law” by ALAN N. RECHTSCHAFFEN is certainly a valuable contribution to the body of academic literature on financial markets and instruments. As the current crisis showed, events on US financial markets can have profound consequences to the whole world economy. Hence, I would recommend the reviewed book not only to US law students and professionals dealing with financial instruments, but also to those who are merely interested in the subject. Finally, I would gladly welcome an updated edition of the book that would cover the recent developments on financial markets and the new propositions regarding the reform of the regulatory regime.

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8 Let us consider two abstract examples – an asset, which price stood only at 80, 100 and 120 with equal frequency, and an asset, which price once amounted to 80 and once to 120 and in all other cases remained at 100. While both assets have the same range of price values, it would be counterintuitive to say their volatility is the same.

9 The alleged misuse or overuse of fair value measurement was said to have contributed to the severity of the financial markets crash. The author himself draws attention to the fact, that once the crisis started, the investors were unable to measure the value of mortgage-backed and asset-backed securities (this concerns only securities measured at fair value) so mentioning this concept in a text on seems useful. More on valuation methods: US GAAP issued by the FASB.

10 The views presented in this review are author’s own and should not be treated as the views of the institutions he is associated with.

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