Defusing the Derivatives Time Bomb: Some Proposed Solutions

By Ellen Brown – Web of Debt

The "protected class" is granted "safe harbour" only because their bets are so risky that to let them fail could crash the economy. But why let them bet at all?

This is a sequel to a Jan. 15 article titled "**Casino Capitalism and the Derivatives Market: Time for Another 'Lehman Moment'?**", discussing the threat of a 2024 "black swan" event that could pop the derivatives bubble. That bubble is now over ten times the GDP of the world and is so interconnected and fragile that an unanticipated crisis could trigger the collapse not just of the bubble but of the economy. **To avoid that result, in the event of the bankruptcy of a major financial institution, derivative claimants are put first in line to grab the assets — not just the deposits of customers but their stocks and bonds. This is made possible by the Uniform Commercial Code, under which all assets held by brokers, banks and "central clearing parties" have been "dematerialized" into fungible pools and are held in "street name."**

This article will consider several proposed alternatives for diffusing what Warren Buffett called a time bomb waiting to go off. That sort of bomb just detonated in the Chinese stock market, contributing to its fall; and the result could be much worse in the U.S., where the stock market plays a much larger role in the economy.

The Chinese Derivative Crisis

A Jan.30 article on Bloomberg News notes that "Chinese stocks' brutal start to the year is being at least partly blamed on the impact of a relatively new financial derivative known as a snowball. The products are tied to indexes, and a key feature is that when the gauges fall below built-in levels, brokerages will sell their related futures positions."

Further details are in a Jan. 23rd article titled "'Snowball' Derivatives Feed China's Stock Market Avalanche." It states, **"China's plunging stock market is leading to losses on billions of dollars worth of derivatives linked to the country's equity indexes, fuelling further selling as retail investors offload their positions…. Snowball products are similar to the index-linked products sold in the 2008 financial crisis, with investors betting that U.S. equities would not fall more than 25% or 30%," which they did.**

Chinese shares rose on Feb. 6, as officials took measures to prop up the ailing market, including imposing new "zero tolerance" curbs for malicious short selling.

The Greater U.S. Threat

The Chinese stock market is much younger and smaller than that in the U.S., with a much smaller role in the economy. **Thus China's economy remains relatively protected from disruptive ups and downs in the stock market. Not so in the U.S., where speculating in the derivatives casino brought down international insurer AIG and investment bank Lehman Brothers in 2008, triggering the global financial crisis of 2008-09. AIG had to be bailed out by the taxpayers to prevent collapse of the too-big-to-fail derivative banks, and Lehman Brothers went through a messy bankruptcy that took years to resolve.**

In a December 2010 article on *Seeking Alpha* titled "Derivatives: The Big Banks' Quadrillion-Dollar Financial Casino," attorney Michael Snyder wrote, **"derivatives were at the heart of the financial crisis of 2007 and 2008, and whenever the next financial crisis happens, derivatives will undoubtedly play a huge role once again…. Today, the world financial system has been turned into a giant casino where bets are made on just about anything you can possibly imagine, and the major Wall Street banks make a ton of money from it. The system … is totally dominated by the big international banks."**

The Speculators Dominate the Regulators

In a 2009 Cornell Law Faculty publication titled How Deregulating Derivatives Led to Disaster, and Why Re-Regulating Them Can Prevent Another, **Prof. Lynn Stout proposed stabilizing the market by returning to 20th century derivative rules. She noted that derivatives are basically wagers or bets, and that before 2000, the U.S. and U.K. regulated derivatives primarily by a common-law rule known as the "rule against difference contracts."** She explained:

The rule against difference contracts did not stop you from wagering on anything you liked: sporting contests, wheat prices, interest rates. But if you wanted to go to a court to have your wager enforced, you had to demonstrate to a judge's satisfaction that at least one of the parties to the wager had a real economic interest in the underlying and was using the derivative contract to hedge against a risk to that interest…. Using derivatives this way is truly hedging, and it serves a useful social purpose by reducing risk.

Under the rule against difference contracts and its sister doctrine in insurance law (the requirement of "insurable interest"), derivative contracts that couldn't be proved to hedge an economic interest in the underlying were deemed nothing more than legally unenforceable wagers.

Hedge funds, for example, should really call themselves "speculation funds," as it is quite clear they are using derivatives to try to reap profits at the other traders' expense.

The rule against difference contracts died in 2000, when the US embraced wholesale deregulation with the passage of the Commodity Futures Modernization Act (CFMA):

The CFMA not only declared financial derivatives exempt from CFTC or SEC oversight, it also declared all financial derivatives legally enforceable. The CFMA thus eliminated, in one fell swoop, a legal constraint on derivatives speculation that dated back not just decades, but centuries. It was this change in the law—not some flash of genius on Wall Street—that created today's $600 trillion financial derivatives market.

The Casino Gets Special Privileges

Not only are speculative derivatives now legally enforceable, but under the Bankruptcy Act of 2005, derivative securities enjoy special protections. Most creditors are "stayed" from enforcing their rights while a firm is in bankruptcy, but many derivative contracts are exempt from these stays. Similarly, under the Dodd Frank Act of 2010, derivative claimants have "super-priority" in the bankruptcy of a financial institution. They are privileged to claim collateral immediately without judicial review, before bankruptcy proceedings even begin. Depositors become "unsecured creditors" who can recover their funds only after derivative, repo and other secured claims, assuming there is anything left to recover, which in the event of a major derivative crisis would be unlikely.

That's true not only of the deposits in a bankrupt bank but of stocks, bonds and money market funds held by a broker/dealer that goes bankrupt. ***Under the Bankruptcy Act of 2005 and Sections 8 and 9 of the Uniform Commercial Code (UCC), "safe harbour" is provided to entities described in court documents as "the protected class." The customers who purchased the assets have only a "security entitlement," a weak contractual claim to a pro rata share of a residual pool of fungible assets all held in the name of Cede & Co., the proxy of the Depository Trust and Clearing Corp. (DTCC). As Wall Street financial analyst John Rubino put it in a Jan. 27 podcast:***

What we used to think of as a bank bail-in where they take your deposit in order to support a failing bank, that is now spread across the entire financial economy where whatever you have in an account anywhere can just disappear, because they're going to transfer ownership of it to these big dominant entities out there in the financial system that need those assets in order to keep from blowing up.

Derivative speculators are considered "secured" because they post a portion of what they could wind up owing as "margin," but why that partial security is superior to the 100% security posted by the depositor or purchaser is not explained. The "protected class" is granted "safe harbour" only because their bets are so risky that to let them fail could crash the economy. But why let them bet at all?

The Solution of the Regulators

The fix of the G20 leaders following the global financial crisis, however, was to force banks to clear over-the-counter derivatives through central counterparties (CCPs), which stand between buyer and seller and protect either party if the other blows up. By March 2020, 60% of credit default swaps and 80% of interest rate swaps were centrally cleared.

The problem, as noted in a December 2023 publication by the Bank for International Settlements, is that these measures taken to protect the system can actually amplify risk.

CCPs tend to ask for more collateral than banks did in the pre-crisis world; and when a CCP hikes its initial margin requirement to cover the risk of default, this applies to everyone in the market, meaning cash calls are synchronized. As explained in a May 2022 Reuters article:

It's logical that CCPs ask for more collateral during a panic: that's when defaults are most likely. The problem is that margin calls seem to have made things worse. In March 2020, for example, a so-called "dash for cash" saw investors liquidate even prime money-market funds and U.S. Treasury securities.

Rampant margin calls have intensified a financial panic twice in as many years, with central banks effectively bailing out markets in 2020. That's better than in 2008, when taxpayers had to step in. But the problem of margin calls remains unsolved.

Central counterparty (CCP) clearing houses should consider asking clients for more collateral during good times to reduce the risk of destabilising margin calls during a financial panic, a Bank of England official said on May 19.

Yet all this, as Michael Snyder observes, is to allow the big international banks to run the largest derivatives casino that the world has ever seen. Why not just shut down the casino? Prof. Stout's suggested solution is for Congress to return to the pre-2000 rule under which speculative derivative bets were not enforceable in court. That would include reversing the "superpriority" privileges in the Bankruptcy Act of 2005 and the Dodd-Frank Act. But it won't be a quick fix, as Wall Street and our divided Congress can be expected to put up a protracted fight.

What If the DTCC Goes Bankrupt?

In a 2015 law review article titled "Failure of the Clearinghouse: Dodd-Frank's Fatal Flaw?," Prof. Stephen Lubben points to a more ominous risk from pushing all derivatives onto exchanges; and that concern is shared by former hedge fund manager David Rogers Webb in his 2024 book "The Great Taking." The exchanges are supposed to be safer than private over-the-counter trades because the exchange steps in as market maker,

accepting the risk for both sides of the trade. But in a general economic depression, the exchanges themselves could go bankrupt. No provision for that is made in the Dodd-Frank Act, which purports to decree "no more bailouts." Still, reasons Prof. Lubben, the government would undoubtedly step in to save the market from collapse.

His proposed solution is for Congress to make legislative provision for nationalizing any bankrupt exchange, brokerage or Central Clearing Counterparty before it fails. This is something to which our gridlocked Congress might agree, since under current circumstances it would not involve any major changes, wealth confiscation or new tax burdens; and it could protect their own fortunes from confiscation if the DTCC were to go bankrupt.

Other Possible Federal Solutions

Another alternative that not only could work but could fix Congress's budget problems at the same time is to impose a 0.1% tax on all financial transactions. See Scott Smith, A Tale of Two Economies: A New Financial Operating System, showing that U.S. financial transactions (the financialized economy) are over $7.6 quadrillion, more than 350 times the U.S. national income (the productive economy). See my earlier article summarizing all that here. On a financial transaction tax curbing speculation in derivatives, see also here, here and here.

There are other possible solutions to customer title concerns. There is no longer a need for the archaic practice of holding all securitized assets in the street name of Cede & Co. The digitization of stocks and bonds was a reasonable and efficient step in the 1970s, but today digital cryptography has gotten so sophisticated that "smart contracts" can be attached by blockchain-like distributed ledger technology (DLT) to digital assets, tracking participants, dates, terms and other contractual details. The states of Delaware and Wyoming have explored maintaining corporate lists of stockholders on a state-run blockchain; but predictably, the measures were opposed. The practice of holding assets in street name has proven very lucrative for the DTCC's member brokers and banks, as it facilitates short selling and the "rehypothecation" of collateral.

In October 2023, the DTCC reported that it has been exploring adopting DLT; but the goal seems only to be speedier and safer trades. No mention was made of returning registered title to the purchasers of the traded assets, which could be done with distributed ledger technology.

South Dakota's Innovative Solution

The most readily achievable solution is probably that in a South Dakota bill filed on Jan. 29. The bill is detailed in a Feb. 2 article titled "You Could Lose Your Retirement Savings in the Next Financial Crash Unless Others Follow This State's Lead", which observes:

If your broker … were to go bankrupt, the broker's secured creditors (the people to whom the broker owes money) would be empowered to take the investments that you paid for in order to settle outstanding debts….

To avoid a catastrophe in the future, a nationwide movement is desperately needed to alter the existing Uniform Commercial Code. Of course, that won't be easy to accomplish, especially because bank lobbyists and other powerful financial interests will almost certainly fight kicking and screaming to stop policymakers from taking away their advantage over consumers.

The good news is this "great taking" can be stopped at the state level. Americans don't need to count on a divided Congress to get the job done. Because the UCC is state law, state lawmakers can take concrete steps to restore the property rights of their constituents and protect them in the event of a financial crisis.

On Monday, South Dakota legislators introduced a bill that would do just that. The legislation would ensure that individual investors have priority over securities held by brokerage firms and other intermediaries.

It would also alter jurisdictional provisions so that cases are determined in the state of the individual investor, rather than the state of the broker, custodian or clearing corporation. This would ensure that individual investors are able to rely on the laws of their local state.

Hopefully, other states will follow South Dakota's lead. Tennessee, for one, is reported to have such a bill in the works.