

Fall 2009

Regulate OTC Derivatives By Deregulating Them

Lynn A. Stout

Cornell Law School, ls483@cornell.edu

Follow this and additional works at: <http://scholarship.law.cornell.edu/facpub>

 Part of the [Banking and Finance Commons](#), [Corporation and Enterprise Law Commons](#), and the [Securities Law Commons](#)

Recommended Citation

Stout, Lynn A., "Regulate OTC Derivatives By Deregulating Them" (2009). *Cornell Law Faculty Publications*. Paper 754.
<http://scholarship.law.cornell.edu/facpub/754>

This Article is brought to you for free and open access by the Faculty Scholarship at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Faculty Publications by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.

Should derivatives be considered unenforceable gambling contracts?

Regulate OTC Derivatives by Deregulating Them

BY LYNN A. STOUT

UCLA School of Law

When credit markets froze up in the fall of 2008, many economists pronounced the crisis inexplicable and unforeseeable. Lawyers who specialize in financial regulation, and especially the small cadre who specialize in derivatives regulation, knew better. (Some had even predicted the crisis; see the Readings below.) That's because the roots of the catastrophe lay not in changes in the markets, but changes in the law. In particular, the credit crisis can be traced to Congress's 2000 passage of the Commodity Futures Modernization Act, which radically altered the traditional legal approach to financial derivatives.

This shift in the legal treatment of financial derivatives has brought the banking system to its knees. The leading cause of the credit crisis was widespread uncertainty over insurance giant AIG's trading losses in the new and rapidly growing market for credit default swaps (CDSs), a kind of derivative bet that issuers will not default on their bond obligations. Because AIG was part of an already enormous and poorly understood web of CDS bets and counter-bets among the world's largest banks, investment funds, and insurance companies, when AIG collapsed, many of those firms worried that they too might soon be bankrupt. Only a massive \$180 billion government-funded bailout of AIG prevented the entire system from imploding.

This could have been avoided if we had kept the traditional approach to derivatives regulation.

Wait a minute, some readers might say. What do you

mean, traditional approach to derivatives regulation? Aren't derivatives some new, modern financial "innovation" that has never been regulated?

Well, no. Derivatives have a long history that offers four basic lessons. First, derivatives contracts have been used for centuries, possibly millennia. Second, while derivatives can be useful for hedging, they are also ideal instruments for speculation. Third, excessive speculation is linked with a variety of economic ills, including increased systemic risk when derivatives speculators go bust. Fourth, derivatives speculation traditionally has been "regulated" not through heavy-handed bans on trading, but through a curious but effective rule that protected and enforced derivative contracts used for hedging purposes while declaring purely speculative contracts to be legally unenforceable wagers. This rule of unenforceability encouraged speculators to rely on private ordering and to develop and police their own private markets (exchanges). Exchanges in turn limited systemic risk.

HISTORY OF DERIVATIVES

Finance economists and Wall Street traders like to surround derivatives with confusing jargon. Nevertheless, the idea behind a derivative contract is quite simple. Derivatives are not really "products" and they are not really "traded." They are simply bets on the future — nothing less and nothing more. Just as you might bet on which horse you expect to win a horserace, you can bet on whether interest rates on bank deposits will rise or fall by entering an interest rate swap contract, or bet on whether a bond issuer will repay its bonds by entering a credit default swap contract.

These sorts of commercial wagers are neither new nor particularly innovative. Although derivatives have gone by many different names, they have been around for centuries.

Lynn A. Stout is the Paul Hastings Professor of Corporate and Securities Law at the UCLA School of Law.

A previous version of this article, entitled "How Deregulating Derivatives Led to Disaster, and Why Re-Regulating Them Can Prevent Another," appeared in *Lombard Street* (July 6, 2009), published by FinReg21.com.



Originally, most commercial derivatives were bets on the future prices of agricultural commodities, like the rice derivatives traded in Japan in the 15th century or the corn and wheat futures traded on the Chicago Mercantile Exchange today. To use the language of derivatives traders, the “underlying” — that is, the thing being bet upon — was the future market price of rice, wheat, or corn.

The first financial derivatives may have been stock options, which were common by the 1800s. The 1990s saw an explosion in other types of derivatives contracts, including bets on interest rates (interest rate swaps), credit ratings (credit default swaps), and even weather derivatives. By 2008, the notional value of the derivatives market — that is, the size of the outstanding bets as measured by the value of the things being bet upon — was estimated at \$600 trillion. This figure amounts to about \$100,000 in derivative bets for every man, woman, and child on the planet.

This sudden development of an enormous market in derivative contracts was not the result of some new idea or innovation. Rather, it was a consequence of dramatic shifts in the legal status of speculative derivatives trading.

DERIVATIVES REGULATION

Just as derivatives have been around for centuries, so have different forms of derivatives regulation. In the United States and the United Kingdom, derivatives traditionally were subject to a common-law rule known as the “rule against difference contracts.” As described in the 1884 U.S. Supreme Court case of *Irwin v. Williar*, the rule against difference contracts allowed you to wager on anything you liked, from sporting contests, to wheat prices, to interest rates. But — here is the catch — the rule did require that if you wanted a court to enforce your wager, you had to demonstrate to the judge’s satisfaction that at least one of the parties to the wager either held title to the underlying thing being bet on, or was legally obligated to take title to the underlying. A CDS contract, for example, would only have been enforced if one of the parties actually owned the bonds on which the CDS was written. Similarly, an interest rate swap would only have been enforced to the extent one of the parties was paying or receiving interest on a bond or cash deposit. In other words, the rule against difference contracts required that, in order for a derivative contract to be legally enforceable, one of the parties to the contract had to be using the contract

to hedge against a preexisting economic risk.

This was allowed because wagers can be useful for hedging against risk. For example, if you own a corporate bond and you are worried the issuer might default, you can hedge that risk by entering a CDS contract, essentially betting against the issuer's creditworthiness. If the bond decreases in value, the CDS increases. Similarly, if you own a \$500,000 home, you can hedge the risk your home will burn down by making a bet with a fire insurance company to pay you \$500,000 if the home actually burns. (Most of us call these wagers "insurance," although a Wall Street derivatives dealer might label them "home value swaps.") Using derivatives this way is truly hedging, and it serves a useful social purpose by reducing risk.

But as common-law judges recognized for centuries, derivative bets are also ideally suited for pure speculation. Speculation is the attempt to profit not from producing something, or even from providing investment funds to someone else who is producing something, but from predicting the future better than others predict it. A speculator might, for example, try to make money predicting wildfires by buying fire insurance on houses in Southern California without actually owning the houses themselves. Similarly, a speculator might hope to profit from betting on a company's fate by buying CDSs on the company's bonds without buying the bonds themselves.

Speculation is a zero-sum game where one party's trading gains always mirror the other's trading losses. But at least when a speculator trades with a hedger, the trade reduces the hedger's risk. When a speculator trades with another speculator, however (one speculator thinks prices or interest rates or credit ratings are going up, the other thinks they're going down), speculation increases speculators' risks, much the same way gambling increases gamblers' risks. Highly speculative markets are also historically associated with asset price bubbles, reduced returns, price manipulation schemes, and other economic ills.

Common-law judges accordingly viewed purely speculative contracts with suspicion. 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 for at least one of the parties were deemed nothing more than legally unenforceable wagers.

FROM PRIVATE ORDERING TO PUBLIC ENFORCEMENT

This didn't mean derivatives couldn't be used to speculate. But the rule against difference contracts forced speculators to think about how to make sure their fellow gamblers paid their bets. The answer was for the speculators to set up private exchanges, like the Chicago Mercantile, with membership requirements, margin requirements, netting requirements, and a host of other rules designed to make sure that, despite the legal invalidity of speculative contracts, speculating traders would make good on their contract promises.

In the process, the private exchanges kept derivatives speculation within reasonable limits and under controlled con-

ditions. This did not stop the government from eventually creating agencies like the Commodities Futures Trading Commission and the Securities and Exchange Commission to regulate trading on particular exchanges. But off the exchanges, the old common-law rule against difference contracts served as the primary check against speculation in "over the counter" (OTC) derivatives.

At least, it kept OTC speculation in check until the rule was dismantled. The dismantling began when the UK passed its Financial Services Act of 1986, "modernizing" its financial laws by making all financial derivatives, whether used for hedging or for speculation, legally enforceable. U.S. regulators, worried that Wall Street banks might lose out on a lucrative new market, followed suit in the 1990s by creating ad hoc regulatory exemptions for particular types of financial derivatives like currency forward contracts and interest rate swaps. The legalization of OTC interest rate swaps was promptly followed by the swaps-fueled bankruptcies of Orange County, Calif., in 1994, Barings Bank in 1995, and hedge fund Long Term Capital Management (LTCM) in 1999. Nevertheless, despite these object lessons, the U.S. Congress embraced wholesale legalization of OTC financial derivatives in 2000 with the Commodities Futures Modernization Act.

The 2000 act declared financial derivatives exempt from CFTC or SEC oversight. But it also declared all financial derivatives legally enforceable. The act thus eliminated, in one fell swoop, a legal hurdle to OTC 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 derivatives market.

SPECULATION AND SYSTEMIC RISK

The results have proven unfortunate, to say the least. Yet it's surprising the newly unleashed OTC derivatives market didn't lead to economic disaster even sooner. Well before AIG, derivatives speculation had already led to the collapse not only of Orange County, Barings Bank, and LTCM in the 1990s, but also to Enron's 2001 bankruptcy and to the implosion of investment bank Bear Stearns in 2008, a few months before AIG's fall.

These examples illustrate why it is essential for policymakers thinking about how derivatives affect systemic risk to distinguish (as common-law judges did) between the use of derivatives contracts for hedging and their use for pure speculation. Hedging provides a social benefit by reducing the hedging party's risk. But when speculators trade with other speculators, they increase their risks, just as gamblers increase their risks by betting with other gamblers. Unchecked derivatives speculation thus adds risk to the system by making it possible for individual speculators like AIG (and Orange County, Barings, LTCM, Enron, and Bear Stearns) to lose very large amounts of money very unexpectedly.

But wait, some readers might say. Couldn't AIG have been an unusual case, a rogue insurance company that succumbed to speculative fever? Isn't it possible most financial derivatives users wisely confine their derivatives deals to true hedging?

Given the stigma attached to speculation, it is not sur-

prising that most parties to derivatives contracts claim, at least in public, that they use derivatives for hedging and not for speculation. In some cases this seems a rather transparent attempt at deception. (Hedge funds, for example, are really speculation funds, as it is quite clear they are in the business of trying to reap profits at other traders' expense.) Perhaps more often, derivatives traders incorrectly describe themselves as "hedging" when they are really "hedging a bet" and using derivatives to offset some of the risk associated with taking a speculative position. This is much the same as the race-track gambler who claims she is "hedging" when, in addition

experiment. It is almost as if Congress said to itself, "Let's see what happens if we suddenly removed centuries of law!" Now we know what happens. The experiment has not turned out well.

What to do? The answer seems obvious: go back to what worked well before. By refusing to devote public resources to enforcing an OTC derivatives contract unless at least one of the parties to the contract either owned or was legally obligated to take ownership of the asset underlying the contract, the common-law rule against difference contracts created an elegant legal sieve to separate socially useful hedging contracts from risk-increasing, purely speculative wagers. Courts

The rule against difference contracts created a sieve to separate socially useful hedging contracts from risk-increasing, purely speculative wagers.

to betting on a particular horse to win, she also buys a ticket for the horse to show.

Despite all the hedging talk, the data suggest speculation drives the OTC derivatives markets. For example, we know the CDS market was dominated by speculation in 2008. We know this because by the end of that year, the notional value of the CDS market had reached \$67 trillion, according to the Bank for International Settlements (BIS). At the same time, the total market value of all the underlying bonds issued by U.S. companies outstanding was only \$15 trillion, according to the BIS. When the notional value of a derivatives market is more than four times larger than the market for the underlying, it is a mathematical certainty that most derivatives trading is speculation, not hedging. And business history — including very recent history — shows derivatives speculation increases systemic risk.

It is possible, of course, that derivatives speculators provide other benefits to the market to offset the social cost of this increased systemic risk. Although from a returns perspective speculation is a zero-sum game — one trader's gain necessarily comes at another trader's expense, just as gamblers can only make money by taking money away from other gamblers — economists sometimes claim that speculators add useful liquidity to markets or that speculation can improve the accuracy of market prices. The derivatives industry routinely repeats this mantra. Yet there is virtually no empirical evidence to establish the value of the supposed liquidity and "price discovery" benefits from derivatives speculation, much less evidence that shows the value of those benefits exceeds the enormous social cost of the systemic risk created by derivatives speculation. Taxpayers have spent nearly \$180 billion on the AIG bailout alone.

WHAT TO DO?

Although few observers appreciated it at the time, the sudden legalization of OTC financial derivatives was a novel legislative

and parties had little difficulty distinguishing the two categories, just as today courts still only enforce, and insurance companies still only write, insurance policies for parties who have an insurable interest.

The rule against difference contracts thus operated as a no-cost, hands-off system of OTC derivatives regulation. (There is no cheaper form of government intervention than refusing to intervene at all, even to enforce a deal.) This "regulation by deregulation" did not stop speculators from using derivatives. But it did require speculators to be much more careful about their counterparties and to avoid derivatives deals with counterparties they thought might come to regret — and try to avoid performing — their part of the bargain. It also encouraged derivatives speculators to organize private exchanges where speculation could take place in an environment where traders were well-capitalized and knew who was trading what, with whom, when. This approach kept runaway speculation from adding intolerable risk to the financial system. And it did not cost a penny of taxpayer money.

During the roaring 1990s, when financial derivatives were being widely applauded as risk-reducing, highly efficient (and, for Wall Street, highly profitable) financial "innovations," the old rule against difference contracts had little appeal. Maybe it has more now. R

Readings

- "Betting the Bank: How Derivatives Trading Under Conditions of Uncertainty Can Increase Risks and Erode Returns in Financial Markets," by Lynn A. Stout. *Journal of Corporate Law*, Vol. 21 (1995).
- "Irrational Expectations," by Lynn A. Stout. *Legal Theory*, Vol. 3 (1997).
- "Prophet and Loss," by Rick Schmitt. *Stanford Magazine*, March/April 2009.
- "Why The Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives," by Lynn A. Stout. *Duke Law Journal*, Vol. 48 (1999).