Casino Capitalism and the Derivatives Market: Time for Another 'Lehman Moment'?

By Ellen Brown

Reading the tea leaves for the 2024 economy is challenging. On January 5th, Treasury Secretary Janet Yellen said we have achieved a "soft landing," with wages rising faster than prices in 2023. But critics are questioning the official figures, and prices are still high. Surveys show that consumers remain apprehensive.

There are other concerns. On Dec. 24, 2023, Catherine Herridge, a senior investigative correspondent for CBS News covering national security and intelligence, said on "Face the Nation," "I just feel a lot of concern that 2024 may be the year of a black swan event. This is a national security event with high impact that's very hard to predict."

What sort of event she didn't say, but speculations have included a major cyberattack; a banking crisis due to a wave of defaults from high interest rates, particularly in commercial real estate; an oil embargo due to war. Any major black swan could prick the massive derivatives bubble, which the Bank for International Settlements put at over one quadrillion (1,000 trillion) dollars as far back as 2008. With global GDP at only $100 trillion, there is not enough money in the world to satisfy all these derivative claims. A derivative crisis helped trigger the 2008 banking collapse, and that could happen again.

The dangers of derivatives have been known for decades. Warren Buffett wrote in 2002 that they were "financial weapons of mass destruction." James Rickards wrote in *U.S. News & World Report* in 2012 that they should be banned. Yet Congress has not acted. This article looks at the current derivative threat, and at what might motivate our politicians to defuse it.

What Regulation Hath Wrought

Derivatives are basically just bets, which are sold as "insurance" — protection against changes in interest rates or exchange rates, defaults on loans and the like. When one of the parties to the wager has a real economic interest to be protected – e.g. a farmer ensuring the value of his autumn crops against loss — the wager is considered socially valuable "hedging." But most derivative bets today are designed simply to make money from other traders, degenerating into what has been called "casino capitalism."

In 2008, derivative trading brought down investment bank Bear Stearns and international insurer A.I.G. Both institutions could not be allowed to fail, because the trillions of dollars in credit default swaps on their books would have been wiped out, forcing their counterparty banks and financial institutions to write down the value of their own risky and now "unhedged" loans. Bear and A.I.G. were bailed out by the taxpayers; but the Treasury drew the line at Lehman Brothers, and the market crashed.

Under the rubric of "no more bailouts," the Dodd Frank Act of 2010 purported to fix the problem by giving derivatives special privileges. Most creditors are "stayed" from

enforcing their rights while a firm is in bankruptcy, but many derivative contracts are exempt from these stays. Counterparties owed collateral can grab it 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. We saw this **"bail-in" policy** play out in Cyprus in 2013.

That's true for deposits, but what of stocks, bonds and money market funds? Under the Uniform Commercial Code (UCC) and the Bankruptcy Act of 2005, **derivative securities also enjoy special protections**. "Safe harbor" is provided to privileged entities described in court documents as "the protected class." Derivatives enjoy "netting" and "close-out" privileges on the theory that they are a major source of systemic risk, and that allowing claimants to jump ahead of other investors in order to net and close out their bets reduces that risk. However, **critical analysis has shown** that derivative "super-priority" in bankruptcy can actually increase risk and propel otherwise viable financial entities into insolvency.

It is also highly inequitable. The collateral grabbed to close out derivative claims may be *your* stocks and bonds. In a 2016 *American Banker* article called "**You Don't Really Own Your Securities; Can Blockchains Fix That?**", journalist Brian Eha explained:

In the United States, publicly traded stock does not exist in private hands.

It is not owned by the ostensible owners, who, by virtue of having purchased shares in this or that company, are led to believe they actually own the shares. Technically, all they own are IOUs. The true ownership lies elsewhere.

While private-company stock is still directly owned by shareholders, nearly all publicly traded equities and a majority of bonds are owned by a little-known partnership, Cede & Co., which is the nominee of the Depository Trust Co., a depository that holds securities for some 600 broker-dealers and banks. For each security, Cede & Co. owns a master certificate known as the "global security," which never leaves its vault. Transactions are recorded as debits and credits to DTC members' securities accounts, but the registered owner of the securities — Cede & Co. — remains the same.

What shareholders have rather than direct ownership, then, "is a [contractual] right against their broker…. The broker then has a right against the depository institution where they have membership. Then the depository institution is beholden to the issuer. It's [at least] a three-step process before you get any rights to your stock."This **attenuation of property rights** has made it impossible to keep perfect track of who owns what.

Fifty Years of "Dematerialization"

In a 2023 book called ***The Great Taking*** (available for free online), Wall Street veteran David Rogers Webb traces the legislative history of these developments. The rules go back 50 years, to when trading stocks and bonds was done by physical delivery – shuffling paper certificates bearing titles in the names of the purchasers from office to office. In the 1970s, this trading became so popular that the exchanges could not keep up, prompting them to turn to "dematerialization" or digitalization of the assets. The **Depository Trust Company (DTC)** was formed in 1973 to alleviate the rising

volumes of paperwork. The DTCC was established in 1999 as a holding company to combine the DTC and the National Securities Clearing Corporation (NSCC).

The DTCC is a central clearing counterparty (CCP) sitting at the top of a pyramid of banks, brokers and exchanges. All have agreed to hold their customers' assets in "street name," collect those assets in a fungible pool, and forward that pool to the DTCC, which then trades pooled blocks of stock and bonds between brokers and banks in the name of its nominee Cede & Co. The DTCC, a private corporation, owns them all. This is not a mere technicality. **Courts have upheld** its legal ownership, even in **a dispute with client purchasers**. **According to the DTCC website**, it provides settlement services for virtually all equity, corporate and municipal debt trades and money market instruments in the U.S., and central safekeeping and asset servicing for securities issues from 131 countries and territories, valued at $37.2 trillion. In 2022 alone, the DTCC processed **2.5 quadrillion dollars in securities**.

The governing regulations are set out in Uniform Commercial Code (UCC) sections 8 and 9, covering investment securities and secured transactions. The UCC is a set of rules produced by private organizations without an act of Congress. It is not itself the law but is only a recommendation of the laws that states should adopt; but the UCC has now been adopted by all 50 U.S. states and has been "harmonized" with the rules for trading securities in Europe and most other countries.

The **Wikipedia summary** of the relevant UCC provisions concludes:

The rights created through these links [up the collateral chain] are purely contractual claims …. This decomposition of the rights organized by Article 8 of the UCC results in preventing the investor to **revindicate** [demand or take back] the security in case of bankruptcy of the account provider [the broker or bank], that is to say the possibility to claim the security as its own asset, without being obliged to share it at its prorate value with the other creditors of the account provider.

You, the investor, have only a contractual claim against your broker, who no longer holds title to your stock either, since title has been transferred up the chain to the DTCC. Your contractual claim is only to a pro rata share of a pool of the stock designated in street name, title to which is held by Cede & Co.

Rehypothecation: The Problem of Multiple Owners

The *Wikipedia* entry adds:

This re-characterization of the proprietary right into a simple contractual right may enable the account provider [the "intermediary" broker or bank] to "re-use" the security without having to ask for the authorization of the investor. This is especially possible within the framework of temporary operations such as **security lending**, **option to repurchase**, **buy to sell back** or **repurchase agreement**.

"Security lending" by your broker or other intermediary may include lending your stock to short sellers bent on bringing down the value of the stock against your own financial interests. **Illegal naked short selling is also facilitated** by the impenetrable shield of the DTCC, and so is lending to "shadow banks" for the re-use of collateral. As Caitlin Long, another Wall Street veteran, **explains**:

[T]he shadow banking system's lifeblood is collateral, and the issue is that market players re-use that same collateral over, and over, and over again, multiple times a day, to create credit. The process is called "rehypothecation." Multiple parties' financial statements therefore report that they own the very same asset at the same time. They have IOUs from each other to pay back that asset—hence, a chain of counterparty exposure that's hard to track. Although improving, there's still little visibility into how long these "collateral chains" are.

It is this reuse of the collateral to back multiple speculative bets that has facilitated the explosion of the derivatives bubble to ten times the GDP of the world. It should be the collateral of the actual purchaser, but you, the purchaser, are at the bottom of the collateral chain. Derivative claims have super priority in bankruptcy, ostensibly because the derivative edifice is so risky that their bets need to be cleared.

What About the "Customer Protection Rule"?

Broker-dealers argue that their customers' assets are protected under the "Customer Protection Rule" of the Securities Investor Protection Corporation (SIPC). The SIPC provides insurance for stocks similar to FDIC insurance for bank deposits, maintaining a pool that can be tapped in the event of a member bankruptcy. But a 2008 memorandum on The Customer Protection Rule from the law firm Willkie Farr & Gallagher asserts:

With respect to cash and securities not registered in the name of the customer, but held by the broker- dealer for the customer's benefit, the customer would receive a pro rata portion of the aggregate amount of the cash and securities actually held by the broker-dealer. If there is a remaining shortfall, SIPC would cover a maximum of $ 500,000, only $ 100,000 of which may be a recovery for cash held at the broker- dealer.

… [M]ost securities are held by broker-dealers in street name and would be available to satisfy other customers' claims in the event of a broker- dealer's insolvency.

If the member has a large derivatives book (JPMorgan holds $54.4 trillion in derivatives and a mere $3.4 trillion in assets), derivative customers with priority could wipe out the pool and the SIPC fund as well.

What Webb worries about, however, is the bankruptcy of the DTCC itself, which could wipe out the entire collateral chain. He says the DTCC is clearly under-capitalized, and that the startup of a new Central Clearing Counterparty is already planned and pre-funded. If the DTCC fails, certain protected creditors can take all the collateral, upon which they will have perfected legal control.

Defensive Measures

In the event of a cyberattack that destroys the records of banks and brokers, there could be no way for purchasers to prove title to their assets; and in the event of a second Great Depression, with a wave of 1930s-style bank bankruptcies, derivative claimants with super-priority can take the banks' assets without going through bankruptcy proceedings. In today's fragile economy, these are not remote hypotheticals but are real possibilities, which can wipe out not just the savings of middle class families but the fortunes of billionaires.

And there, argues Webb, is our opportunity. The system by which Cede & Co. holds title to all "dematerialized" securities is clearly vulnerable to being exploited by "the protected class," and Congress could mitigate those concerns by legislation. If our representatives realized that they are not the owners of record of their assets but are merely creditors of their brokers and banks, they might be inspired to hold some hearings and take action.

The first step is to shine a light on the obscure hidden workings of the system and the threat they pose to our personal holdings. Popular pressure moves politicians, and the people are waking up to many issues globally, with **protests on the rise everywhere** — economic, political and social. Possible action that could be taken by Congress includes **reversing the "special privileges"** granted to the derivatives casino in the form of "super priority" in bankruptcy. A **0.1% Tobin tax or financial transaction tax** is another possibility. For protecting title to assets, blockchain is a promising tool, as discussed by Brian Eha in the *American Banker* article quoted above. These and other federal possibilities, along with potential solutions at the local level, will be the subject of a followup article.