Commentary: Proposed Derivatives Regulation Could Signal a Bottom

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On May 13, 2009, Treasury Secretary Geithner announced the Obama administration's proposals to regulate over-the-counter derivatives. Secretary Geithner's proposal would involve significant changes to existing law affecting the SEC, CFTC, State insurance regulators and federal and state banking regulators. It is also clearly intended to limit the scope of financial innovation that has done so much to enhance the incomes of investment bankers and financial services lawyers during the last two decades.

Sweeping changes in regulation are often imposed after the crisis that spawns them is past, closing the door after the cow has left the barn. Secretary Geithner's proposal may be something of a leading indicator that the financial crisis is nearing its end.

Secretary Geithner's announcement claims that current law largely excludes or exempts over-the-counter derivatives from regulation. This is not entirely accurate. The most fundamental of derivatives is an option. Over-the-counter equity options have been regulated, primarily by FINRA, since the early dawn of federal securities regulation.

It is nonetheless painfully true that the SEC and CFTC, the primary regulators of derivatives, are forbidden under current law from regulating a type of derivative known as a "swap." It is these evil first cousins of options that brought down the house of AIG, threatening to throw the entire globe's banking system into default, and have so far exposed the US taxpayer to a potential loss in the neighborhood of $200 billion.

Derivatives truly are, as described by Warren Buffett in 2003, "financial weapons of mass destruction." In 2003, the harm Buffett described was largely theoretical. Aside from a few scary episodes, there were no clear historical examples of economic mass destruction caused by derivatives. Now we know better. The current financial crisis has demonstrated the harm such instruments can cause, leading the public to demand their regulation.

All financial instruments are contracts, which might be defined as a promise or set of promises enforceable in a court of law. Ordinary securities issued in financing transactions -- stocks and bonds -- are relatively tame because, in addition to being contracts, they also constitute a property right. In each case, they represent claims on the assets of a corporate issuer.

Derivatives do not represent claims on assets, but rather claims that use asset claims as a frame of reference. As a result, their counterparties are not limited by the nature of a set of assets, but are free to agree to just about anything that can be expressed as a promise. There would seem to be no limit to the complexity of a promise; contracts are infinitely flexible and can be tailored to meet just about any business or social objective. Similarly, there are an infinite number of derivative financial instruments that might be engineered, limited only by market forces and regulation.

Market forces limit the creativity of financial engineers because at some point it is not worth the effort (or legal fees) required to understand when and how the counterparties to a financial instrument will pay or receive payment. And, an idiosyncratic financial instrument is difficult to resell because any potential buyer would also have to go through the effort of understanding it. As a result, market forces tend to foster the evolution of standardized financial instruments. Swaps, for example, tend to be written using a form produced by the International Swaps Dealers Association (ISDA). There are a few variables, but the basic terms are relatively consistent from one swap to another. Moreover, swaps originators tend to limit their variability, which makes them easier to sell.

The purchase and sale of ordinary securities generally is limited by regulations imposing disclosure requirements. Disclosure is the least limiting form of regulation because this is just a matter of the seller providing information to the buyer about the offered financial instrument. But, information is expensive to produce, and this expense is a hurdle that limits the marketability of securities.

Disclosure has never been thought sufficient to properly regulate derivatives. For example, while there are disclosure requirements for options, the sale of options, including options sold over-the-counter, is also regulated by limiting the amount of options any one party can own. Position limits are intended to prevent options from becoming financial weapons of mass destruction by limiting the amount of destruction any one party can inflict or incur. However, position limits also prevent a willing and fully informed purchaser from buying options from a willing and ready seller. There is nothing more frustrating for an options dealer than to be forced to tell a customer that they will have to take their business somewhere else because the dealer or the customer has reached the limit.

One cure for this frustration is to seek the advice of a lawyer skilled in financial engineering. Most derivatives, with a bit of creativity, can be transformed into some other derivative subject to different regulatory requirements, but with the same economic results. For example, an option can be transformed into a future by simply transforming the option from a right to purchase an asset on a certain date into a promise to actually make the purchase. By simultaneously selling a put option for the same price with the same exercise date, the owner of the future has the same economic result as a person that only purchases a call option.

Of course, it doesn't do much good to buy single stock futures to avoid position limits on calls because futures are more heavily regulated than options. But, the economic results from just about any derivative, with a bit of creative drafting, can be achieved through some combination of swaps. And, swaps are not regulated.

For many years, Alan Greenspan and most other financial regulators argued that market forces alone were adequate to limit the destructive potential of swaps. My guess is that they would have happily removed the regulation of other derivatives, as well, but it just wasn't worth the political fuss.

Now that we know better, Secretary Geithner proposes sweeping regulation of all derivatives. Instead of position limits, all over-the-counter derivatives dealers and other firms who create large derivatives positions would be subject to capital requirements and required to report their positions to regulatory authorities. Standardized derivatives would be cleared through a central counterparty and traded only on regulated exchanges, but capital and reporting requirements would apply to all derivatives. Position limits would be strengthened. Finally, new requirements would be imposed that would limit the types of counterparties permitted to purchase derivatives. Retail investors would not be permitted to play.

For my money, the most interesting thing about the proposal is that it doesn't seek to target any particular derivative. In this way, it differs from the proposals circulating in Congress that would allow the SEC or CFTC to regulate swaps, for example. Otherwise, once the crisis is past, financial engineers would attempt to create some "new" derivative, fix a new name on it, and try to convince the regulators to ignore economic reality and see it as something that shouldn't be subject to regulation. Casting a wide regulatory net restrains financial creativity.

The Congress elected in the depth of the Great Depression was convinced that "puts and pools" were its causes and determined to wipe these financial evils from the face of the earth. What we got from all that was the Securities Exchange Act, adopted in 1934. By the time of its adoption, the economy had long since bottomed out. Secretary Geithner's proposed regulation of derivatives may be one more indication that we are nearing something of a bottom in the long-running financial crisis that began nearly two years ago.