The Bane of Derivatives

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No less a figure than Warren Buffet has blamed derivatives for the current crisis in financial markets. The resulting recession, he believes, will be long and deep. Warren isn't getting any younger. The claim that derivatives have caused financial crisis is at least as old as he is.

The Congress that produced the Securities Exchange Act of 1934, which introduced regulatory supervision to the nation's securities markets, blamed the Great Depression on the financial industry generally and on two things in particular: Puts and Pools. Today, we would call Pools hedge funds. Puts are derivatives. Despite the legislative animosity set forth in the Congressional Record, the Exchange Act doesn't purport to regulate either puts or pools.

The reason the Exchange Act is silent about these two great boogey-men is that the first inclination of Congress was to ban them from the face of the earth. Modern options traders can thank the ancient Puts and Calls Association of New York for preserving their jobs. This group lobbied mightily to convince Congress that a flat prohibition would be a big mistake. When Congress decided that banning derivatives might be throwing the baby out with the bath, they were at a loss to decide how to regulate them. When Congress found the topic mystifying, showing how little has changed in the world of derivatives, they decided to duck, that favorite by far of legislative tools. The newly-formed SEC was instructed to study and solve the problem of derivatives. The fact that Warren Buffet still thinks derivatives are a problem suggests that in seven decades the SEC has not yet come up with a satisfactory solution.

If we think of any property as a bundle of rights, a derivative is simply a way of selling one of the underlying rights that accompany ownership of a security. For example, stock represents ownership in a corporation. One of the rights implicit in ownership is the right to enjoy the fruits of capital appreciation. A call option is one way of selling the right to that capital appreciation within a certain period of time while retaining all the other rights of ownership.

Thought of this way, there are two risks present that bothered the SEC at first blush. The first is that nothing requires the person selling an option to own the underlying stock. While the owner of the stock can always deliver it when the option is called, a naked seller must have other funds available to satisfy the option holder.

This means that there is some risk that the counterparty will not deliver. The SEC solved this problem by instituting a central counterparty to issue all exchange-traded options.

The second risk is that supplied with a certain amount of money, a person can purchase the right to much more capital appreciation by buying derivatives than through purchases of the underlying stock. Leverage is an important feature of any derivative. Add a bit of margin and you have a truly volatile stew. To limit the market impact of this leverage, the SEC imposed position limits that prevent any one person from owning too much of any particular option.

How successful has the SEC's regulation of derivatives been? On the one hand, quite successful. I can't think of a single financial crisis since 1929 caused by problems in the options markets. It can also be argued that the regulation of derivatives has been a dismal failure. Derivatives have been major players in almost every financial crisis since 1929, and crisis has visited the U.S. financial markets at least once in every decade.

The reason for this is that options, besides representing somewhat peculiar property interests, are also contracts, and contracts are very flexible instruments. It is possible to achieve the same economic results with other contracts that do not fall within the definition of an option. Swaps, repurchase agreements and futures are all contracts that designed in particular ways will achieve all of the same results as options contracts. However, the regulatory protections of options – a central counterparty and position limits – do not apply to these other financial instruments. Many of these instruments are arguably beyond the jurisdictional reach of the SEC. The ability to design contracts that will avoid regulatory reach is limited only by creative ability of the legal mind. The legal imagination knows no limits.

Freedom of contract is an important constitutional right and a principal feature of a free society. Our economic system is predicated on the principle that this right should be limited only to the extent necessary to protect the public interest. The regulation of options was viewed as necessary to avoid the harm resulting from economic collapse. As a society, we have been reluctant to impose similar restraints on other forms of derivatives contracts. The current financial crisis will test this resolve, particularly if the recession we are now experiencing becomes truly long and deep.

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