Banking by John Hoefle

G-30 admits derivatives are illegal

The bankers' "widely adopted approach" is to ignore the laws against derivatives speculation.

"It is a recognized concern in Australia that a derivative may be classified as a gaming or wagering contract," the Australian law firm of Mallesons Stephen Jacques stated in the recent Group of Thirty (G-30) report entitled "Derivatives: Practices and Principles," after warning that "all states and territories in Australia have legislation which invalidates agreements which are classified as gaming or wagering contracts."

"There is a view held by a number of commentators that derivatives are protected from invalidity under the gaming and wagering legislation where one party enters into the derivative on a genuine commercial basis—for example, to hedge its risk," the opinion continued. "However, we are unable to find authority which expressly supports that proposition. The problem is that this raises a degree of uncertainty for a party who is entering a derivative for purely speculative purposes as that party will have to take steps to ensure that the counterparty has a genuine commercial basis for entering into the derivative."

Furthermore, the law firm stated, "There is a risk that certain derivatives could be classified as an insurance contract, especially where there is an amount (which can be likened to a premium) paid at the time the derivative is entered into and where the derivative reasonably accurately reimburses a counterparty for any loss it may suffer due to an adverse movement in the market.

"This has been an issue for a long period in Australia and the widely adopted approach is to ignore the terms of the Insurance Act when considering trading in derivatives. However, the problem remains and it would be helpful if the Insurance Act were amended to provide that derivatives were excluded from its provisions."

The G-30, a Washington, D.C.-based front group for the big international banks and the central banks, pretends that derivatives transactions are adjuncts to legitimate business deals, but such claims are ludicrous. At the end of 1992, about $12 trillion in derivatives contracts were outstanding worldwide, on a turnover estimated at $80-100 trillion a year. Daily trading of derivatives in the United States runs at approximately $300 billion, or roughly the same size as the federal government's acknowledged budget deficit. If these derivative transactions were supporting real economic activity, the world's economies wouldn't be in a depression.

Derivatives are, as House Banking Committee Chairman Henry B. Gonzalez (D-Tex.) observed in June of this year, "a fancy name for gambling." As bets on the future movements of interest rates, currencies, and commodities, derivatives have more in common with casino games such as roulette and blackjack, than they do with legitimate economic activity.

This, as Mallesons Stephen Jacques warned, poses a big problem for the bankers.

In fact, the G-30's law firms found significant legal problems with derivatives in all nine countries studied (Australia, Brazil, Canada, England, France, Germany, Japan, Singapore, and the United States).

In Brazil, "it is not possible under Brazilian law to enforce oral agreements involving amounts of more than approximately U.S.$900," the report said. Given that many derivatives transactions are entered into via telephone, this poses a significant problem. Furthermore, the report said that Brazil's Civil Code, which renders waging contracts unenforceable, "provides that certain sorts of derivatives transactions . . . will be treated as wagering contracts in that they are settled in accordance with the difference between an agreed price and their quoted price at the expiration of the transaction."

In England, where wagering contracts are also void, "most derivatives contracts are likely to fall within" the Financial Services Act's exemptions from the Gaming Act, but "there may be certain transactions which . . . do not," the report stated.

In France, where the issue of gaming and wagering "has been largely resolved by legislation . . . it is thought that this wording would cover most types of transactions currently used in the derivatives sector."

In Japan, much of the regulation is through "administrative guidances" to specific companies through the Ministry of Finance or the Ministry of International Trade and Industry, making it "almost impossible to state definitively what the current regulatory position of the government is with respect to specific business areas such as swap transactions. . . . It is very difficult, in reality, to distinguish between hedging and/or investment from speculation. . . . Currently, we can argue that swap transactions . . . are outside of the application of the anti-gambling provisions because they are entered into with legitimate business reasons."