Historical Review of the Financial Service Industry's Use of Client Securities as Collateral

Exposition of the Widespread Industry Practice of Pledging Client Securities as Collateral, 1968 to the Present. Chronological Review of Changes in Law Legalizing the Use of Client Securities. Analysis of Risk Exposure to Investors & Proposals for Reform.

James Patrick

E-mail: info@TheGreatTakingReport.com

Keywords: Securities, Securities Entitlement, Securities Entitlement Holder, DTCC, Deposit Trust Corporation, Deposit Trust Clearing Corporation, Euroclear, Derivatives, Derivatives Complex, Central Securities Depository Regulations, Property Rights, Central Clearing House.

Abstract

This paper documents that the financial services industry is utilizing all securities worldwide as collateral many times over in rehypothecated collateral chains. All financial securities are housed in "dematerialized" pooled and fungible form—in the United States at the Deposit Trust Clearing Corporation, and in the European Union at Euroclear of Belgium—in what is termed the "indirect holding system." From these central securities depositories, all financial securities are being utilized as collateral by the largest banks, free of payment and without the widespread knowledge of individual clients and institutional funds. This unrestricted use of clients' assets as collateral began in the 1970s with the establishment of the central securities depositories. It became a widespread industry practice in the 1980s, and is now referred to as "collateral management." All securities, of both individual and institutional clients, are now utilized in a globally automated fashion many times over in "collateral chains." In this paper, we examine the economic implications of this practice. Moreover, we outline and critique the legal structures enacted to legally formalize this practice in the United States through the 1994 revision of Article 8 of the Uniform Commercial Code and the Central Securities Depository Regulations in the EU in the 2000s. Finally, we explicate the resultant explosion of the derivatives market following the legal formalization of this industry practice. This paper concludes with legal recommendations for the restoration of property rights to securities worldwide, as well as predictions of the economic implications if those property rights are not restored.

Keywords: Securities, Securities Entitlement, Securities Entitlement Holder, DTCC, Deposit Trust Corporation, Deposit Trust Clearing Corporation, Euroclear, Derivatives, Derivatives Complex, Central Securities Depository Regulations, Property Rights, Central Clearing House.

1. Introduction

All financial securities in the United States and Western European markets, and, by extension, the securities of most of the world—due to capital flows through the New York City and London and EU financial centers—are being used as collateral by the highest levels of the financial services industry, for their derivatives positions, many times over in collateral chains.[i] This practice poses a significant threat to property rights in securities, violates the constitutions of

many Western countries, and represents a significant legal departure away from the sanctity of property rights, as well as the rule of law, and towards a form of feudalism, where a "protected class" of "too big to fail" (TBTF) financial institutions have a legal privilege and priority to the financial assets of others in a financial crisis.

This practice of the largest banks in the world—secretly using all financial securities of the public as collateral on their own derivatives contracts—has led to an unsustainable expansion (bubble) of the global derivatives market to an estimated 1.5 quadrillion USD. (Derivatives contracts are financial bets on price movements of currencies or commodities that require collateral to place.) This corresponding growth in the derivatives market, fueled by the biggest bank's free use of all clients' securities, threatens global financial stability and places all holders of securities, both individual and sophisticated institutional investors, at risk of loss in a widespread market crisis scenario.

This practice was legalized in the United States with the 1994 revision of the Uniform Commercial Code (UCC), and later in the European Union via the modification of the Belgian Constitution in 1973, and later via the Central Securities Depository Regulations (CSDRs). Furthermore, priority to all securities was given to the secured creditors of the derivatives contracts, in the event the derivatives market collapses.

This free use of client assets as collateral on derivatives contracts *must stop* and full property rights to financial assets must be restored. What began as a surreptitious practice has become a widespread and institutionalized. Although not widely known by the public, or even by sophisticated investors, this practice is an open secret in the highest levels of the financial services industry. Fortunately, the derivatives market can be peacefully wound down through a prohibition on the use of clients' securities. In order for this to happen, the clandestine use of client accounts and later securities needs greater attention and critique for the damage it does to the rule of law, property rights as well as the economic distortions these activities cause.

2. The History of the Progressive Use of Client Assets as Collateral

The industry practice of using client assets as collateral emerged in the early 1970s with the establishment of central securities depositories (CSDs).

The idea to house all securities in pooled form in CSDs was proposed in the late 1960s by a study committee called the Banking and Securities Industry Committee (BASIC), which was established to find a solution to the "paperwork crisis." They argued that moving away from the use of share certificates and towards a bookkeeping entry system would create greater market efficiency. Severing direct ownership of individual clients to individual share and bond certificates and substituting it with an indirect holding system where all securities were kept in a fungible form, it was argued, was a necessary step to "modernize" the financial system. In fact, this development diminished property rights in securities as it distanced the client from their property and transferred legal title to a financial intermediary—above the common broker—that held the securities in pooled fungible form. In this indirect holding system, all securities are no longer held by their broker or custodian, who only maintain a bookkeeping entry, but instead at a higher level at the CSDs. In other words, when one buys a stock or bond from his broker, who uses a custodian, these financial intermediaries only have a bookkeeping entry that the client bought and holds a certain number of any given securities, but the CSD has no records of any individual client's holdings. Actual legal control of the purchased securities is transferred to the CSD.

The term "dematerialization" refers to that transition from individual clients holding physical share and bond certificates to simply owning electronic entries of securities held in pooled, fungible form by financial intermediaries.

…

The process of dematerialization started in 1968 with the "paperwork crisis"[ii] on Wall Street. Five years later, it culminated in the creation of the Deposit Trust Corporation (DTC) in New York City in 1973. Most accounts of the 'paperwork crisis' state that the growth in transaction volume at the NYSE in the late 1960s caused a burdensome load of paperwork to deliver signed physical share certificates from buyer to sellers and settle them in a reasonable amount of time.[iii] It remains unclear if this was a genuine issue that necessitated compromising property rights to securities or if it was simply a rationalization used to get all securities into a pooled and fungible form where they could be efficiently utilized as collateral by the largest banks. Either way, the "paperwork crisis" of 1968 was used as the justification to immobilize all securities in pooled form at the DTC, which later had its name changed to Deposit Trust Clearing Corporation (DTCC) in 1990. The legal owner of all securities held at DTCC is Cede & Company, a financial institution that processes transfers of stock certificates on behalf of DTC.[iv]

The very fact that the putative "solution" to the "paperwork crisis" of pooling all securities in a fungible fashion without individually attributing title to individual clients wasn't even implemented until 4 years later indicates this "crisis" wasn't as pressing of a matter as we are meant to believe. Furthermore, the repeated claim that compromising property rights in financial securities was necessary to create efficiency also doesn't hold water technically. This is evidence by the fact that the Nordic countries complied with

The implementation of a digitally managed holding system that correctly attributes property rights to clients is feasible and in fact existed in the Nordic countries from early 1970s up until to 2014.[v]

Concurrently in 1968, the Brussels office of Morgan Guarantee Trust Company (later renamed JP Morgan and Company) formed Euroclear, which is the primary central securities depository in Western Europe.

…

As the Eurodollar market emerged after World War II with the influx of US dollars into Western Europe, due in part to the Marshal Plan, many European banks began holding balances in US dollars which were not regulated by their national governments. They began making loans in these dollar balances and eventually began issuing loans in dollars out of thin air. In this emerging market of dollar loans in Europe, no regulations applied and the banks began issuing loans without any underlying dollar reserves at all, and this burgeoning market of dollar loans began to be called the "Euro-dollar market."[vi]

The dollar as a world reserve currency is more appropriately understood as the result of the Eurodollar market.[vii] These "Eurodollars" are not regulated by the US Treasury or Federal Reserve as they reside outside of their jurisdictions. Coinciding with this practice of reserve-less loans in the Eurodollar market, a greater attention was given by the banking industry to "innovating" in exotic ways by utilizing collateral as the basis of extending loans and fictionalizing markets. In the 1970s, after the founding of DTCC and Euroclear, the financial services industry began moving to securitize financial assets with a focus on banking activities centered around the use of collateral. Beginning in this period, the financial services industry began to utilize their clients' securities as collateral for their own gain. Correspondingly, by the 1980s, the DTCC shifted from strictly serving as a central securities depository to also providing collateral management services to its members. Essentially, the member banks that use DTCC for custodial services began to encumber the assets of their clients, housed at DTCC, using client assets as collateral on their derivatives contracts. This activity was facilitated and managed by DTCC. The widespread adoption of this practice facilitated the growth of the over-the-counter derivatives trade. This gradually developed into the encumbrance of all securities in circulation; those of individuals and large institutional funds, and even securities held in 'segregated' accounts were kept in the same pools and utilized as collateral all the same. This placed the DTCC in a critical position and established them as a central infrastructure provider. This practice eventually evolved into what is became known as the field of 'Collateral Management.'

Industry actors told the author of this paper who worked as bankers in the Eurodollar banking system during the 1970s to the present have indicated that extensive use of client securities as collateral on the derivatives market occurred in the 1980s.

The Group of Thirty, often abbreviated to G30, is a private, non-profit international body composed of academic economists, company chiefs, and representatives of national, regional, and central banks. The G30 was founded in 1978 by Geoffrey Bell at the initiative of the Rockefeller Foundation, which also provided initial funding for the body. The G30 published a study in 2003 entitled "Global Clearing Settlement: A Plan of Action." It stated:

> The Group of Thirty commissioned this study of global securities clearing and settlement arrangements out of concern that unevenly developed national clearing and settlement infrastructure and inconsistent business practices across markets could be a source of significant systemic risk, and certainly of inefficiency.[viii]

3. "Segregated Accounts" Are Not Segregated When in Dematerialized Form

Even when clients are told their assets are held in "segregated" accounts, their securities are still being freely used as collateral. Evidence of this can be found in an EU Clearing and Settlement, Legal Certainty Group Questionnaire to the New York Federal Reserve. This document is a formal legal response by lawyers at the Federal Reserve to the EU Legal Certainty Group answering their questions regarding their mandate to harmonize the 1994 Article 8 revisions of the UCC into the laws of the EU and each member state.

The EU Legal Certainty Group asked:

> Where securities are held in pooled form (e.g. a collective securities position, rather than segregated individual positions per person), does the investor have rights attaching to particular securities in the pool?[ix]

The Federal Reserve lawyers answered clearly:

> No. The security entitlement holder does not have rights attaching to particular securities in the pool, he has a *pro rata* share of the interests in the financial asset held by its securities intermediary to the amount needed to satisfy the aggregate claims of the entitlement holders in that issue. This is true even if investor positions are "segregated."[x]

It is important to understand that this use of client assets was not just done one time, but multiple times over in collateral chains, whereby the same securities would be used as

collateral again and again on many derivatives contracts. This created legal problems of priority over who would get the client collateral in the case of insolvency of the financial intermediaries to the derivatives contracts. Would it be the *client* whose assets were used, or would it be the *secured creditor* to the derivatives contracts within which the securities were encumbered? This issue of legal priority will be addressed in a subsequent paper, but it is brought up here to illustrate why the financial services industry sought to establish legal certainty over this, in what could easily be considered a fraud or embezzlement of client assets.

4. The Legalization of the Fraudulent Use of Client Assets as Collateral in the United States in the 1990s and the European Union from 2004 -2014

As the fraudulent use of client assets grew, the financial services industry pushed to legalize the practice to protect themselves. This resulted in the 1994 revision of Article 8 of the UCC. The UCC is a body of laws enacted on the state level to facilitate commerce and trade between the states, and Article 8 is the section that specifically deals with financial securities.

This was passed into law in all the 50 states between 1994 and 2000. It created two important legal changes to the ownership of securities. The first dealt with priority of claims in the event of insolvency of the financial intermediary, which will be dealt with in another paper. The second significant change was the new legal concept of the "security entitlement."

Let us draw attention to the Article 8 1994 revision of the UCC to illustrate the authorizing language and deceptive nature of the revision. Quoting the UCC code itself, the article 8 revision, section 504 reads that "(a) A securities intermediary shall promptly obtain and thereafter maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its entitlement holders with respect to that financial asset."[xi] And it adds: "(b) Except to the extent otherwise agreed by its entitlement holder."[xii] In plain English, this means the DTCC must keep on hand the securities to back the securities entitlement (contractual claims on those securities) and cannot encumber them without the written permission of the clients. This is all good. But then it states, "(d) This section does not apply to a clearing corporation that is itself the obligor of an option or similar obligation to which its entitlement holders have security entitlements."[xiii] This means the statements in parts (a) and (b) do not apply to DTCC, or Central Clearing Counterparties owned by DTCC, that encumber those securities into an "option or similar obligation", i.e. a derivative contract. Upon reading the beginning of section 504, one is led to believe property rights are maintained by the securities intermediary, but the exception in (d) simply says (a) and (b) don't apply and the property rights of the entitlement holders can be completely ignored by DTCC and the Central Clear Counterparties it owns.

The 1994 revision of Article 8 of the UCC created a new legal construct. Direct ownership of a financial security was substituted with a contractual claim on a security, called a "Securities Entitlement." With this came the legal distinction between the "legal owner" and the "beneficial owner.". The central securities depository, i.e. DTCC, became from that point on the "legal owner" that maintained "control" and title to the security, while the client maintained "beneficial ownership" of the security. The "beneficial owner," is the "securities entitlement holder" who owns a bundle of rights that constitute all the economic benefits of ownership of a security, (such as voting rights) and receives dividends from those securities, but does not maintain legal ownership, or legal title to the underlying security. The "legal owner", i.e. the Central Securities Depository (DTCC), on the other hand, can allow their members to encumber the client's securities and dispose of them as it sees fit. This presents a huge violation of the property rights of all owners of securities, as their direct ownership of securities was substituted with a fungible contractual claim, thereby enabling the financial services industry to encumber all the client assets to their own benefit many times over in rehypothecated collateral chains.

A significant point to remember about a contractual claim, such as a securities entitlement, is its priority in bankruptcy proceedings. When a person or entity goes bankrupt, a contractual claimant comes last in line, behind secured creditors. So, in the event of a system wide derivatives market meltdown, entitlement holders would have a very weak legal claim to their assets.[xiv] The 1994 Article 8 revision stipulated that an entitlement holder's property interest with respect to a particular financial asset is a pro rata property held by the securities intermediary (DTCC), without regard to when the entitlement holder acquired the security entitlement or when the securities intermediary acquired the interest in that financial asset.

In the EU, the establishment of the indirect holding system started in 1967 with a Royal decree in Belgium that paved the way for the establishment of Euroclear, the International Centralized Securities Depository (ICSD) of Europe. The EU set up a working group in 2004 to essentially copy the Article 8 revision of the UCC. The name was "Legal Certainty Group." A July 26, 2006, Legal Certainty Group questionnaire to the European Commission stated:

> The core legislation relating to fungible securities holdings is Belgian Royal Decree no. 62- which is a law and not merely a regulation- of 10 November 1967 as coordinated by Royal Decree of 27 January 2004 […][xv]