Indemnity of Fraud: How Changes to the UCC and US Bankruptcy Law Shield the Derivatives Industry from Client Claims in the Event of Bankruptcy

A Review and Analysis of the Laws and Regulations Granting the Derivatives Industry Priority in Bankruptcy and Legal Indemnification Against Client Claims of Fraud; How Changes to the UCC "Safe Harbor" provisions of the Bankruptcy Code, 546(e) Exceptions and the Lehman Brothers Bankruptcy Decision Creating a "Protected Class."

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Abstract

This paper documents and critiques the progression of legal and regulatory changes made over the last 30 years that granted the financial services industry legal priority to all securities on the market, ahead of the entitlement holders (underlying investors), in the event of bankruptcy. These changes in law include the 1994 revision of Article 8 of the Uniform Commercial Code (UCC), changes to the "Safe Harbor" section of the US bankruptcy code (The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), 546(e) exemptions (Financial Netting Improvements Act of 2006) and the legal precedents establish by bankruptcy proceedings of Lehman Brothers and the creation of the quasi-legal concept of a "Protected Class" of "Too Big To Fail," Global Systemically Important Banks (also referred to as Systemically Important Financial Institutions, or SIFI). In the name of promoting financial stability, these changes of law fundamentally undermined the property rights of all investors to securities and grant the world's largest banks priority to take client assets in the event a market crisis, even in the case of constructive fraud. The rational for the establishment of these institutional privileges are presented and critiqued. Legal reforms to the market infrastructure of securities that would better ensure systemic stability and restore property rights to investors are discussed.

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, Legal Priority, Secured Creditors, Collateral, Collateral Chains, Initial Margin, Financial Crisis.

1. Economic First Principles, & The Rule of Law in the Context of Legal Priority

For a marketplace to function there must be a legal system in place where property rights are honored and economic actors can transact with one another without the fear of theft or embezzlement. The property rights of all citizens must be universally allied for markets to function and for the health of society. If certain economic actors or institutions are granted special privileges above the rest, this creates a feudal class system. Allowing the financial services industry to utilize their client's securities undermines the rule of law and

encourages reckless economic behavior that will almost surely result in disaster.

Changes to securities and bankruptcy law were made that have undermined all investor's property rights to their financial securities. This has institutionalized a system of economic feudalism that will, over time, concentrate the capital of society into a fewer and fewer hands.

The emerging practice of the financial service industry surreptitious use of their client's securities began in a haphazard fashion. Over time it became common place for stock brokers, custodians and banks to freely pledge their client's securities or renting them out to other firms for use as collateral. It became hard for anyone to know exactly how many times collateral was being pledged. In the late 1960s, this gave rise to an effort to pool all client securities under one roof at central securities depositories (CSDs), to have a clear view of the level of rehypothecation of collateral. This resulted in the founding of Euroclear in Belgium in 1968 and the Deposit Trust Clearing Corporation in NYC in 1973.

2. Analysis of the 1994 Revision of Article 8 of the Uniform Commercial Code

As financial service providers began holding client securities in pooled accounts, encumbering out of those common accounts, it best suited industry to treat clients as contractual claimants to against the firm's pool. As the collateral market of client securities developed, brokers and custodians began utilizing the central securities depositories to house their securities for them in exchange for collateral management service and greater utilization of their client's assets.

The financial system's unauthorized use of client's securities as collateral constituted fraud and exposed financial services providers to the claims of their clients, should they go bankrupt.

The fraudulent nature of this now common practice constituted a significant legal liability to industry.

A concerted lobbying effort was undertaken by industry to conform the law to industry practice. The first legal reform industry enacted, and arguably the most significant, was the 1994 revision of Article 8 of the Uniform Commercial Code, authored by attorney James S. Rogers.

In a 117-page report, Policy Perspectives on Revised U.C.C Article 8, James S Rogers explains the rational for the revision, that the legal treatment of securities prior to the 1994 revision, failed to protect industry. The financial services industry began a concerted campaign of legal reform to protect themselves:

> […] as the securities settlement system comes to rely increasingly on the book-entry system, the need for an adequate modem legal structure of commercial law rules concerning the system of securities holding through intermediaries becomes more and more pressing. This general concern was the immediate impetus to the Article 8 revision project. In a number of the studies issued after the October 1987 stock market break, it was suggested that uncertainties about the application of the commercial law rules found in old Article 8 to the modem system of securities holding through intermediaries might operate as an impediment to efforts to control or limit risks in times of disturbances in the securities and financial markets.[i]

Not only was this fraudulent practice made legal, but in the event of bankruptcy, legal priority to take client securities was granted to secured creditors, even in cases of constructive fraud and insider dealing. Therefore, industry sought protection from liability of client claims during "times of disturbances in the …. financial markets," when client securities, pledged as collateral, would be taken by secured creditors.

This result was the 1994 revision of Article 8 of the Uniform Commercial Code in the United States, which served as the legal model implemented in EU countries between 2004 and 2014. The EU formed a task force to implement these changes called the "Legal Certainty Group." Their internal documents state the 1994 revision of Article 8 of the UCC in the United States severed as the legal model that was harmonized into EU law.

"Securities Entitlement"

The 1994 revision of Article 8 of the UCC introduced two novel legal concepts. Firstly, it created the legal construct of a "securities entitlement," the owner of which is a "securities entitlement holder."
A client's legal title to a security was substituted with a contractual claim to a security at their financial firm.

The UCC 8 102 defines "Entitlement Holder" as follows: "(7) 'Entitlement holder' means a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary.[ii]

Another important term used in the UCC is a "Securities Intermediary". This refers to a client's broker, or any firm above them, who utilizes the underlying client securities as collateral.

UCC § 8 102 defines Securities intermediary as:

(14) " Securities intermediary " means:

(i) a clearing corporation ; or

(ii) a person, including a bank or broker , that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity."

Given the industry practice of holding all client's securities in pooled accounts, treating clients as contractual claimants against the firm rather than owners of property held in their possession, was favorable for industry. The significance of substituting clear title to a contractual claim is that in a bankruptcy proceeding, contractual claims are very weak and of a lower priority than a secured creditor.

To illustrate the matter better; let's say you took out a loan on your house from a bank and also had open contracts with balances due to the painter, carpenter, gardener etc. If you went bankrupt, the bank would take your house as the secured creditor, and all the contractual claimants owed money, would have to get in line in the bankruptcy proceedings to get paid.

Secured Creditors Have Priority
Ahead of "Entitlement Holders"

The second critical change made by 1994 revision of Article 8 of the UCC was to grant priority to secured creditors ahead of "securities entitlement holders." When client securities are pledged as collateral by their broker, and the broker fails, the secured creditors of the broker have a higher priority to the client's securities, ahead of the client.

As Article 8, Section 511, PRIORITY AMONG SECURITY INTERESTS AND ENTITLEMENT HOLDERS clearly states:

> (a) […] if a securities intermediary does not have sufficient interests in a particular financial asset to satisfy both its obligations to entitlement holders who have security entitlements to that financial asset and its obligation to a creditor of the securities intermediary who has a security interest in that financial asset, the claims of entitlement holders, **other than the creditor,** have priority over the claim of the creditor.
>
> (b) **A claim of a creditor of a securities intermediary** who has a security interest in a financial asset held by a securities intermediary **has priority over claims of the securities intermediary's entitlement holders** who have security entitlements with respect to that financial asset if the creditor has control over the financial asset.[iii]

UCC §8-511 also clarifies that the secured creditors of clearing corporations, firms above the broker level, also have priority to entitlement holders.

> (c) If a clearing corporation does not have sufficient financial assets to satisfy both its obligations to entitlement holders who have security entitlements with respect to a financial asset and its obligation to a creditor of the clearing corporation who has a security interest in that financial asset, the claim of the creditor has priority over the claims of entitlement holders.[iv]

Once securities become posted as collateral on derivatives contracts, the secured creditor of the contract obtains control of the collateral. That secured creditor than has the ability to re-pledge that security as collateral again, enabling the next secured creditor to do the same, leveraging the underlying securities into rehypothecated "collateral chains" undergirding an upside-down pyramid of derivatives contracts. Should these contracts, and the firms making them, fail, a priority contest ensues with multiple secured creditors laying claim to the same underlying collateral.

The fact that the Article 8 revision of the UCC addresses priority, indicates that there exist competing priorities in the market. Competing priorities of creditors could only occur if the financial services industry was using their client's assets as collateral many times over.

This is why industry lobbied to amend the UCC to grant priority to the secured creditors, at the expense of their client's whose securities they were pledging.

The 1994 Article 8 revision of the UCC perversely reversed the legal relationship of the parties involved. The true owners of the securities should have the position of the secured creditors to their property and the financial intermediaries encumbering those securities for their own financial gain should be the contractual claimants, not the other way around.

If a client's private property is pledged by their broker in unauthorized transactions and the broker goes bankrupt, client priority should be unaffected and not even enter the bankruptcy proceedings of their failed broker. If stolen or fraudulently transferred assets are subsequently bought and sold by other parties, the original owners of the absconded property has the right to recover their assets. The notion that the creditors of the unauthorized contracts wrongfully

pledging the victim's assets should have priority, is illegal in non-securities criminal law and absurd on its face. These changes in securities law represent a significant assault on the concept of property rights throughout the world.

A new legal principle was needed to justify the financial industry's use of their client's securities and strip them of their right of recovery in bankruptcy. As James S Rogers, the author of the 1994 revision of Article 8, explains that a new "structural principle" (industry interests) should take priority over "transaction specific" rules (client interests) in the draft approach:

> The fact that securities are used as collateral in a wide variety of transactions, ranging from loans of a few thousand dollars to an individual secured by a physical pledge of certificated securities to multibillion dollar arrangements of baffling complexity, has important consequences for the basic architecture of the secured transaction rules.
>
> We were, after all, a group of generalist commercial lawyers asked to devise sensible rules for transactions that few of us had ever even heard of before we sat at the table…… **There was, however, a very deliberate approach.** In a nutshell, it was this: **Base the rules on general structural factors rather than on factors specific to particular transaction** patterns or specific categories of actors. Thus, as has been discussed above, the key perfection and **priority rules are based upon the general structural principle** that a person who is in a position to have **securities held by a debtor** disposed of without further act of the debtor **should be able to rely on those securities as collateral without concern that the debtor may have granted a conflicting interest to some other party.**" [v]

This passage illustrates that drafter of Article 8 of the UCC was hired to conform the code to the than widespread industry practice. The property rights of individual investors should be subverted in favor of the financial firms secretly using their securities as collateral above them in the system. The casual nature with which he states that the most basic principle of individual property rights should be discarded to benefit of a fraudulent pyramid of conflicting speculative bets is beyond explanation. No thoughtful rational is given to make such a fundamental change in property rights, other than it would be better for economic actors to use the property of others at no cost to them! Why should law be altered to benefit an industry gone awry in a speculative orgy of fraud and abuse?

Clients Only have a "Pro-Rata" Claim to Pooled Securities

On the books of financial firms, client securities were kept in pooled accounts. Should a client's financial intermediary go bankrupt, the most favorable legal treatment for industry would be for the client to only have a 'pro rata' claim to the firm's assets, in other words, they would only be entitled to a proportional share of the remaining assets and not the full value of what was lost.

Mind you the pro rata claim of entitlement holders would come behind the secured creditors, of which there could be many.

As UCC Article 8, Section 503 states:

> (b) **An entitlement holder's property interest** with respect to a particular financial asset under subsection (a) **is a pro rata property interest in all interests in that financial asset held by the securities intermediary ,** without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset.[vi]

The limitation of client claims to only a pro rata share of the bankrupt firm's assets, and given client securities are pledged many times over in rehypothecated collateral chains of derivatives contracts, the likelihood clients could recover their assets is slim to none.

The 'Control' Principle Determines Priority

Article 9 of the UCC code also stipulates that the secured party who has "control" of investment property has priority ahead of a secured party that did not have control. Control simply means the firm that has legal title to a security and can sell it or rent it out at will. Given that all client securities in the financial system are held and controlled by financial intermediaries above them, those firms always maintain "control" of the securities, and therefore always have priority under UCC Article 9-328, ahead of entitlement holders.

As UCC Article 9-328 clearly states:

> (1) **A security interest held by a secured party having control** of investment property under Section 9-106 **has priority** over a security interest held by a secured party that **does not have control** of the investment property.

Rogers explains the rational for the "control principle": "the control principle provides a simple basis for the rules needed to assure legal certainty for systems designed to control risk in the securities settlement process."[vii]

The use of the "Control Principle" to assign priority unfairly benefits the financial services industry at the direct expense of their client's whose assets they manage. The notion that a firm managing client assets should grant them legal priority to take those assets if they go bankrupt makes no legal sense, and violates the most basic concept of property rights.

"Armageddon Planning" was the

Purpose of the 1994 Article 8 Revision

So, what was the broader purpose of revising Article 8 of the UCC? James S. Rogers, the drafter, characterizes it as preparations for a widespread financial crisis.

"The work of which the Article 8 revision project is a part might be described as **"Armageddon planning"** for the financial system… thankfully, people in both governmental bodies and private sector groups who devote a significant portion of their professional activities to contemplating what might happen in the event of major crises in the financial system, such as the unexpected failure of an institution that plays a major role in the national and international financial system, and assessing concrete steps that might be taken to lessen the impact of such events."

According to Rogers, the focus of the Article 8 revision served "lessen the impact" of a financial crisis, but for who? Lowering the priority of investors seeking to recover their assets from a bankrupt firm only lessens the financial losses of the firms involved, at the direct expense of their clients.

3. Changes to Bankruptcy Law "Safe Harbor" in Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)

Another significant legal obstacle to the derivatives industry was bankruptcy law. As it stood, for secured creditors to take client securities on the eve of bankruptcy free of payment would be considered constructively fraudulent or a fraudulent transfer. The way to fix this was broadening the "Safe Harbor" provisions of bankruptcy code to guarantee financial intermediaries could keep client's collateral.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 achieved this by changing "Safe Harbor" provision's treatment of financial transactions, such as forward contracts, commodity contracts, repurchase agreements and securities contracts. Additionally, the Financial Netting Improvements Act of 2006 enacted exceptions 546(e), that specifically excepted sections 547(b) and 548(a)(1)(B) of the bankruptcy code that define fraudulent transfer and constructive fraud.

Prior to the 2005 BAPCPA and FNIA of 2006, the US bankruptcy code considered the transfer of client securities pledged as collateral to secured creditors as "constructively fraudulent" if less than a reasonable equivalent value was received, if the debtor intentionally incurred a debt beyond his ability to pay or was engaged in business for which the debtor had unreasonably small capital. If any of these conditions were met, the transfer of collateral to secured creditors could be reversed in the courts, allowing clients to claw back their securities. Sections 547(b) and 548(a)(1)(B) of the bankruptcy code prohibit actions constituting fraudulent transfer or constructive fraud of property. Client securities could also be recovered if they were transferred less than 90 days prior to a bankruptcy filing and 1 year if the transferee was an insider. Considering that all securities were now being utilized as collateral by industry, free of payment (FoP), and the underlying purchasers of securities had not received anything of reasonable equivalent value in return, US bankruptcy law would allow all service contracts to be void and clients could be allowed recovery.

Stephen J. Lubben, internationally recognized expert in corporate finance and governance, financial distress and debt, expressed concerns about these changes to the "safe harbor" provisions in his book *The Bankruptcy Code Without Safe Harbors.*

Lubben writes:

> Following the 2005 amendments to the Code, it is hard to envision a derivative that is not subject to special treatment.
>
> The safe harbors cover a wide range of contracts that might be considered derivatives, including securities contracts, commodities contracts, forward contracts, repurchase agreements, and, most importantly, swap agreements. The latter has become a kind of 'catch-all' definition that covers the whole of the derivatives market, present and future.[viii]

Lubben adds, "[…] The safe harbors as currently enacted were promoted by the derivatives industry as necessary measures […]."[ix]

4. Critique of the Argument that Changes to Bankruptcy Law Reduce Systemic Risk

Similar arguments to those made by James S Rogers for the Article 8 revision, were made to implement the changes to

'Safe Harbor.' They were necessary to ensure "financial stability" and reduce "systemic risk" As Lubben explains:

The systemic risk argument for the safe harbors is based on the belief that the inability to close out a derivative position because of the automatic stay would cause a daisy chain of failure amongst financial institutions.

The problem with this argument is that it fails to consider the risks created by the rush to close out positions and demand collateral from distressed firms. Not only does this contribute to the failure of an already weakened financial firm, by fostering a run on the firm, but it also has consequent effects on the markets generally . . . the Code will have to guard against attempts to grab massive amounts of collateral on the eve of a bankruptcy, in a way that is unrelated to the underlying value of the trades being collateralized."

Lubben makes the salient point that the changes "Safe Harbor" created perverse incentives within the derivatives industry that encouraged secured creditors to grab more and more collateral in the midst of a crisis. Being able to seize client collateral for which no reasonable value was exchanged, dramatically increases the likelihood of a systemic collapse.

In short, if fraud is legalized, more fraud will occur.

In a 2013 paper presented at a conference held at the Chicago Federal Reserve, professor of Law at Duke University, Steven L. Schwarcz, with co-author Ori Sharon, addressed the questionable assertion the changes to "Safe Harbor" would reduce systemic risk, noting:

> *U.S. bankruptcy law [2005 BAPCPA and subsequent Acts] grants special rights and immunities to creditors in derivatives transactions, including virtually unlimited enforcement rights. […] these rights and immunities result from… a sequence of industry-lobbied legislative steps, each incremental and in turn serving as apparent justification for the next step, without a rigorous and systematic vetting of the consequences. Because the resulting "safe harbor" has not been fully vetted […] regulators, legislators, and other policymakers—whether in the United States or abroad—should not automatically assume, based on its existence, that the safe harbor necessarily reflects the most appropriate treatment of derivatives transactions under bankruptcy and insolvency law or the treatment most likely to minimize systemic risk.*[x]

The resultant expansion of the derivatives market following the 2005 changes to "Safe Harbor" and 2006 546(e) exemptions, proves that these changes had ill effects. The derivatives bubble this created, should it collapse, threatens to wipe out the underlying investors whose securities undergird the derivatives complex.

The doubts Lubben and Schwarcz raise concerning the systemic risk arguments given to justify the granting of broad privileges to industry should be taken seriously. When such changes result in an unprecedented bubble, the greater the risk the bubble will burst.

A noteworthy legal case documenting the risk all investors of securities face, is the bankruptcy decision of Lehman Brothers.

5. Legal Precedent Established by the Lehman Brothers Bankruptcy Case Regarding "Safe Harbor" & the 546(e) Exemptions

The Lehman Brothers bankruptcy establish case law that secured creditors of the derivatives market have legal priority to the underlying client securities in the event of bankruptcy.

Lehman Brothers was actively utilizing their client's assets as collateral on their derivatives trades. JPMorgan was the custodian of Lehman's client securities, as well as the secured creditor of their derivatives contracts, constituting a textbook example of a fraudulent insider transaction. When Lehman Brothers went bankrupt, JPMorgan took the Lehman's client securities who subsequently sued to recover them, claiming the seizure of their assets was constructively fraudulent.

The law firm representing JPMorgan—Wachtell, Lipton, Rosen & Katz—argued in a memorandum filed in support of motion to dismiss the client's claims to reclaim their assets:

> […] the safe harbor provisions, which were enacted by Congress for the express purpose of enabling financial institutions like JPMorgan to conduct business with troubled counterparties in protected markets without fear that their transactions would be disturbed in bankruptcy.[xi]

The court ruled in JPMorgan's favor, that the "safe harbor" provisions of the bankruptcy code allowed them to do so:

> The Court agrees with JPMC that the safe harbors apply here, and it is appropriate for these provisions to be enforced as written and applied literally in the interest of market stability. The transactions in question are precisely the sort of contractual arrangements that should be exempt from being upset by a bankruptcy court under the more lenient

> standards of constructive fraudulent transfer or preference liability: these are systemically significant transactions between sophisticated financial players at a time of financial distress in the markets—in other words, the precise setting for which the safe harbors were intended.[xii]

The Court added:

> […] the Court will strictly construe the plain meaning of section 546(e) in judging whether the claims set forth in the Amended Complaint are subject to the safe harbors of that section of the Bankruptcy Code.[xiii]

In a subsequent section entitled "***A. JPMC qualifies for protection under section 546(e)***," they further write:

> The Court first must consider whether JPMC is eligible for protection under section 546(e). That subsection, like the safe harbors generally, applies only to certain types of qualifying entities.[xiv]

JPMorgan's lawyers motioned the client's claims be dismissed "arguing that they fail as a matter of law because the transfers are fully protected from avoidance under section 546(e) of the Bankruptcy Code."[xv]

Presiding Judge James M. Peck addresses the 546(e) exceptions to the bankruptcy code in his decision:

> […] section 546(e) exempts from avoidance "transfers" by or to "financial institutions" that are made "in connection with" a class of defined "securities contracts." Once parsed, the language is clear, and […] prevents Plaintiffs from [contesting the contractual agreements allowing their securities to be used and the transfers of that collateral] on theories of **constructively fraudulent transfer or preference**.[xvi]

The 546(e) exceptions enacted into law by the Financial Netting Improvement Act of 2006, created a massive loophole for the derivatives industry to use client securities free of legal liability by literally legalizing fraud. 546(e) of the bankruptcy code specifically exempted secured creditors from the fraudulent transfer claims of clients, in the event of bankruptcy.

Language was inserted excepting "a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract."[xvii] The changes to 546(f) and 546(g) added "for the benefit of" before "a swap participant" and "a repo participant" and struct the words 'that is a margin payment, as defined in section 741 or 761 of this title, or settlement payment, as defined in section 741 of this title."[xviii]

Judge Peck notes that "Section 546(e) carves out an express exception to section 547(b) and 548(a)(1)(B),"[xix] granting them exception to:

11 U.S.C. § 547 prohibits "any transfer of an interest of the debtor in property—

> **(1)** to or **for the benefit of a creditor**
>
> **(3)** made **while the debtor was insolvent**;
>
> **(4)** made--
>
> **(A)** on or **within 90 days before the date of the filing** of the petition [of bankruptcy].[xx]

Given that JPMorgan was the creditor to Lehman Brothers and took their client's securities on the eve of Lehman's bankruptcy, the transfer of those securities would be considered fraudulent under UCC 11-547.

And 548(a)(1)(B) prohibits a transfer if the client

> "**(B)(i) received less than a reasonably equivalent value** in exchange for such transfer or obligation; and
>
> **(II)** was engaged in business or a transaction, or was about to engage in business or a transaction, for which any **property remaining with the debtor was an unreasonably small capital**;
>
> **(III) intended to incur**, or believed that the debtor would incur, **debts that would be beyond the debtor's ability to pay as such debts matured**; or
>
> **(IV)** made such transfer to or **for the benefit of an insider**, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.[xxi]

Lehman Brothers was using their client's securities as collateral without compensating them for that use, and did not offer a "reasonably equivalent value in exchange for such transfer or obligation." Prior to the 2006 546(e) exception, these actions would be considered fraudulent.

One must understand that this wasn't an isolated instance and the activities of Lehman were common practice across the industry. The Lehman Brother's bankruptcy proceeding

simply serves to illustrate a single documented instance in the case law.

6. Leverage Necessarily Prohibits Recovery in the Event of Widespread Market Failure

Lehman Brothers had leveraged their client's securities through rehypothecation, necessarily leaving them with "an unreasonably small capital" to cover the losses should the chain of contracts fail. This reckless of client securities incurred "debts that would be beyond the debtor's ability to pay as such debts matured" should their derivatives contracts fail.

Given the rehypothecated nature of the derivatives complex, where client securities are pledged and re-pledged in 'collateral chains', the ability for clients to recover their assets in a widespread failure would necessarily be impossible. The collateral base isn't large enough to cover a derivatives market leveraged 10X, 20X or 100X.

Each derivatives contract requires something called an "initial margin" to be pledged to activate the contract. The vast majority of collateral used within the derivatives market is borrowed short term and posted on longer term contracts. In normal stable market conditions, there is always enough collateral available to borrow, but in periods of crisis, the market for collateral dries up, causing a cascade of failed contracts with secured creditors seizing the collateral. This is referred to as "margin spirals."

US treasury bonds are considered the gold standard of collateral on derivatives contracts. Routinely financial firms enter into swap contracts to swap other securities for US treasuries to meet the collateral requirements of their derivatives contracts. The ratios of leverage within the US treasury futures market indicates a bubble exists within the derivatives market that could burst at some point. If this occurs, all investors in securities could be wiped out.

The best source for data on the size and levels of leverage within the derivatives market is the Bank of International Settlements. In their September 18th quarterly report data on leverage within the market of US treasury futures are provided.
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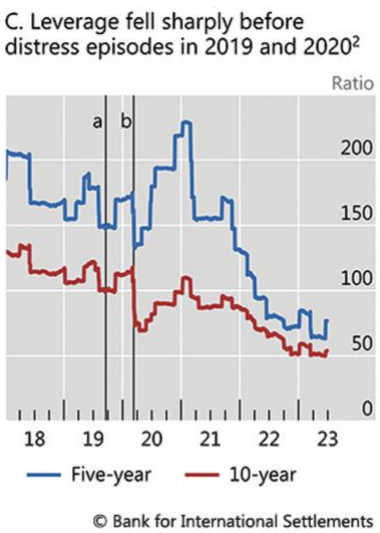

A graph provided in the BIS quarterly report, the leverage levels on speculative positions on US Treasury futures is shown to been over 150X leveraged between the beginning of 2018 to the end of 2021.[xxii]
The report goes on to say "the current build-up of leveraged short positions in US Treasury futures is a financial vulnerability worth monitoring because of the margin spirals it could potentially trigger."[xxiii]

The report "focuses on the often-overlooked leverage associated with futures trading, and how sudden fluctuations in this 'margin leverage' may give rise to destabilizing margin spirals."[xxiv]

Such levels of leverage present risk of widespread failure that are largely unrecognized by market participants. Even large sophisticated investors and CEOs of major banks are unaware of the risk exposure they face in periods of crisis.

James Rickards, in his book *Aftermath*, recounts an interaction he had with Morgan Stanley CEO that illustrates this un recognized risk. He gave a presentation to the board of Morgan Stanley outlining the risk the bank faces of having enough capital to cover their positions in a market crisis. He told the board that "banks don't need capital when markets are calm, interbank liquidity is readily available, and collateral is well-bid. Yet the opposite is true. In a panic, when liquidity dries up, when assets go no-bid, and when everyone wants his money back, no amount of capital is enough. Banks, even good banks, are leveraged and it only takes modest declines in asset values on a leveraged balance sheet to wipe out capital. My point to Gorman was that his improved capital cushion was more than enough for most market conditions, but far from enough for a replay of 2008 on a larger scale."[xxv]

Morgan Stanley CEO James Gorman, heard his presentation and commented to him afterwards that he "strongly disagreed with [Rickard's] assessment that Morgan Stanley and other securities firms were more vulnerable than ever to a financial collapse."[xxvi]

Morgan Stanley risk advisor Keishi Hotsuki said, "Jim, your presentation is music to my ears; I've been saying the same thing for years." He gushed, "I'm so glad you gave this analysis. I want to hug you!" Gorman, the tough Aussie, stood up and quipped, "Keishi, I've been paying you millions for a decade and you've never offered to hug me."[xxvii]

This anecdotal account illustrates that even the CEO of a firm like Morgan Stanley does not fully appreciate the risks a widespread bankruptcy would produce.

"I summarized by saying that capital markets and the banking system were vulnerable to a collapse of unprecedented proportions because of the scale of the system, the dense interconnectedness of mega banks, and flawed risk models."[xxviii]

In 2002, the global derivatives market was estimated to be 128 trillion USD. In 2007, the BIS estimated it was 516T, with market analysts estimating it to be closed to 700T USD. Currently, it is estimated to be 1-2 quadrillion USD.[xxix] 100T USD in 2001 to 700T USD in 2007 necessitated these legal changes to continue to operate at such a scale.

Given the prevalence of widespread fraudulent use of client collateral, the 2005 changes to "Safe Harbor" and the 546(e) exceptions were needed by the derivatives industry to legally protect themselves from client claims.

7. The Establishment of a "Protected Class" of "Too Big to Fail" Global Systemically Important Banks

A concerning line from the Lehman Brother bankruptcy proceeding is the mention that JPMorgan is a member of the "protected class." As Judge Peck states:

> JPMC, as one of the leading financial institutions in the world, quite obviously is a member of **the protected class** and qualifies as both a "financial institution" and a "financial participant.[xxx]

While the term "protected person" and "protected contract" existed in contract law for many centuries where one party could be contractually protected from loss, the concept of a "protected class" was novel to the Lehman decision. The use of such a term poses a threat to the property rights of all investors of financial securities.

The granting of special legal privileges to protected classes of society had not been seen since the medieval feudal period where kings and lords held exclusive rights above the rest of society. By investing the largest financial institutions, a perceptual status of protected persons within a protected class, even as they commit fraud, constitutes a perversion of law of ominous proportions.

As Lubben elaborates upon this in his paper "The Bankruptcy Code Without Safe Harbors,"

> A protected contract ... is only protected if the holder is also a protected person, as defined in the Bankruptcy Code. Financial participants—essentially very large financial institutions—**are always protected**.[xxxi]

No market participant should always be protected from a liability originating from the commission of fraud.

A parallel term promoted by financial authorities on both sides of the Atlantic was "Too Big to Fail" Banks and Systemically Important Financial Institutions (SIFIs). While the term "Too Big to Fail" was punted around by financial authorities for several decades it gained prominence during the 2007-2008 financial crisis. These quasi-legal terms introduced by regulators and financial authorities have served to grant special privileges to the world's largest banks. While the term "Too Big to Fail" is most commonly associated with government bail outs, ht e larger concern is that GSIB/SIFI/ TBTF banks would be given super priority to keep client assets when a widespread market collapse ensues. This precedent is far more concerning and constitutes the emergence of a caste system within the financial system.

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