

Building the Global Market

A 4000 Year History of Derivatives

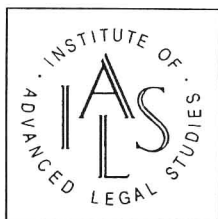


Edward J. Swan

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1. The Case for a History of Derivatives

“The system of agricultural futures trading developed in the United States in the 1850–1900 period in response to the rapidly increasing economic need for centralised pricing and larger-scale risk bearing in agricultural marketing.”¹

1.1 INTRODUCTION

With the collapse of Barings, the expulsion of Daiwa Bank from the USA, the bankruptcy of Orange County and the problems of Long term Capital Management, derivatives and their alleged dangers have had ample media coverage.² However, aside from those dramatic events, two things point to a need for an historical study of derivatives law. First, derivatives trading may now be the world’s biggest business.³ Secondly, despite the fact that some commentators have suggested that trading derivatives may have ancient origins, little has been written about the history of derivatives and even less about their regulatory history.⁴

1.1.1 The Size of the Market

The derivatives market is huge and expanding. As of April 1995, the Bank for International Settlements (BIS) calculated the daily turnover of derivatives markets at around \$2.3⁵ trillion per day.⁶ To put this number in

1. Senate Report No. 93–1131, 93d Cong., 2d Sess. 13 (1974), *reprinted in* [1974] *US Code & Ad. News* 5843, 5853.

2. For examples, see George Sirell, “Daiwa sells US assets to Sumitomo”, *The Times* (London, 30 January 1996), p. 25; William Lewis and Tracy Corrigan, “LTCM fall-out hits another hedge fund”, *Financial Times* (London, 28 September 1998), p. 1.

3. See discussion of the size of the market at Section 1.1.1, below.

4. See discussion of previous written history of derivatives at Section 1.1.2, below.

5. All references to dollars (\$) are to US dollars unless otherwise stated.

6. Bank for International Settlements, *Central Bank Survey of Foreign Exchange and Derivatives Market Activity*, 1995 (Basle, BIS, May 1996), pp. 21–36. This total is a combination of the

perspective, it was reported that a year's total *annual* global turnover in equities is about \$21 trillion, less than ten *days* of derivatives trading. The total *annual* global value of goods and services traded was put at \$4.315 trillion, less than two *days* derivatives turnover.⁷ It may be fair to say that more money changes hands as a result of derivatives than for any other reason.

This could be true for the foreseeable future. The derivatives business has been reported to be growing at a rate of about 14 per cent per year, far ahead of the 3.2 per cent annual rate of growth for the world economy, and about double the 7.1 per cent rate of growth of world trade.⁸

Much of the business is transacted in the UK and the USA. As of April 1995, the largest share of the business (26.9 per cent) was being transacted in the UK, and 15.6 per cent in the USA. The daily turnover is reported to be \$590 billion in the UK, and more than \$360 billion in the USA. The average premium on foreign exchange transactions is about 1 per cent, which means that this trade may be earning approximately \$5.9 billion in revenue in the UK, and about \$3.6 billion in the USA, per *day*. Since 1995, the size of the over-the-counter (OTC) derivatives market has grown by more than 60 per cent.⁹ As can be seen, this is not a business about which either country should want to be unclear.

1.1.2 Derivatives Histories

To date, previous examinations of the history of derivative instruments have been incomplete at best. There are few (and even that numerical characterisation is generous) books written specifically about the history of derivative instruments and/or their regulation. One recent work, Professor Jerry W. Markham's *The History of Commodity Futures Trading and its Regulation* is very cautious in its attempt to describe the early legal history of these transactions. In its first paragraph it describes the history of futures as "obscure" and refers to sources dating to 2000 BC. In its second paragraph it refers briefly to the eighteenth century "to arrive" contracts, in its third acknowledges their use in America, and by the fourth paragraph is discussing the founding of the Chicago Board of Trade (CBOT) in 1848.¹⁰ The rest of that excellent

cont.

BIS figures for daily turnover of the over-the-counter (OTC) foreign exchange and interest rate derivative markets (\$1.162 trillion, after adjustment for double-counting) and the trade in exchange-traded interest rate and futures contract markets (\$1.141 trillion), pp. 32–35. This survey is published every three years.

⁷ *Financial Times*, 24 October 1995, p. 4.

⁸ *International Herald Tribune*, 24 October 1995, p. 15; Testimony of Brooksley Born, Chairperson Commodity Futures Trading Commission Concerning the Over-the-Counter Derivatives Market (Before the US House of Representatives Committee on Banking and Financial Services, 24 July 1998), p. 2.

⁹ "Testimony of Brooksley Born", see note 8, above, p. 2.

¹⁰ (New York, Praeger, 1987), pp. 3–4.

book is devoted to the years after that. This is very useful and informative, but does not give any real sense of any history of derivatives pre-dating 1848.

There are very few other works that attempt to give a history, and even fewer that attempt to give a legal history of derivatives. One general historical work, *From Forums to Futures*, attempts to give a historical perspective on this trade, but deals primarily with commodities trade dating from Roman times, without specifically discussing derivatives (or deferred delivery) contracts until the Middle Ages.¹¹ Histories of particular futures exchanges have been published, but they are sketchy about the existence of derivatives trading before the nineteenth century.¹² Graham L. Rees's *Britain's Commodity Markets* is a good history of the British commodity trade,¹³ but does not argue that derivatives trading began in Britain.

1.2 A DESCRIPTION OF THE BOOK

It is the argument of this book that derivatives and their history of trade and regulation are incompletely understood both by the legal profession and derivatives market regulators. In light of the size and fearsome reputation of the derivative market, these knowledge gaps should be filled.

It is the goal of this book to improve understanding of the huge, and to some worrisome, derivatives market by providing more information about:

- (a) the origins of derivatives;
- (b) their uses;
- (c) the legal regulation of derivatives; and
- (d) sources of information that need further study to increase understanding of derivative markets, their role in commerce and their place in law.

1.2.1 Chapter Descriptions

To divide the research supporting this history into manageable sections, the following chapters are included.

Chapter 1. This first chapter will consider the size and importance of the market for derivatives. It will examine the definitions of derivatives, focusing on definitions of US and UK derivatives regulators. This will be followed by

¹¹. David Courtney, *From Forums to Futures* (London, Credit Lyonnais Rouse, 1991), p. 72.

¹². J.A. Findlay, *The Baltic Exchange* (London, 1927), pp. 1–33; Hugh Barty-King, *The Baltic Exchange: The History of a Unique Market* (London, Hutchinson Benham, 1977), pp. 34–61; S.W. Dowling, *The Exchanges of London* (London, Butterworths, 1929).

¹³. (London, Paul Elek, 1972).

an analysis of what the definitions tell about those regulators' understandings of derivative instruments and the place of derivatives in English and US law (common law).¹⁴ It will include a discussion of the need for a more extensive study of the history of derivatives and their regulation before 1848, the date of the opening of the CBOT.¹⁵

Chapter 2. This chapter will examine the development of commerce and the use of derivatives and their regulation from the dawn of history until approximately 600 BC, a date roughly coinciding with the decline of indigenous empires in the Middle East and the beginning of the ascendancy of Greece and Rome.

Chapter 3. This will discuss the period of 600 BC until the Fall of Rome (traditionally, 476 AD), examining the use of derivatives and their regulation in Greece, Rome and their empires, including the empires ruled by Alexander's successors during that period.

Chapter 4. This chapter will examine the period from the Fall of Rome to Fourth Crusade (1204). This will examine the use of derivatives and their regulation during the so-called Dark Ages, the impact of Germanic tribal law on European legal systems, the rise of the Italian city states and their use of derivatives to expand their commerce, the rise of the Arab empire, and the European re-conquest of the Middle East with the influences that event exerted on European trade and derivatives regulation.

Chapter 5. This chapter will discuss the Medieval use of derivatives contracts in England and Northern Europe, the penetration of the trading and regulation methods of Italian merchant cities into those areas, the rise of Bruges as Medieval Europe's first important central market and derivatives regulation during that period.

Chapter 6. This chapter will review the sixteenth and seventeenth centuries, the Tudor and Stuart eras in England, the rise of Antwerp and Amsterdam as important derivatives markets, their derivatives regulations, and the decline of the Roman Church as an important producer, marketer and regulator of derivatives.

Chapter 7. This chapter will examine the eighteenth century as a period for the expansion of derivatives trade, particularly in England and its American colonies. The importance of London's Royal Exchange, the effect of the South Sea Bubble and the evolution of English law and regulation with respect to derivatives will be discussed.

¹⁴. For purposes of this discussion, including both statutory regulation and judicial decision.

¹⁵. See note 10, above, 4. The reason that the date of the founding of the CBOT has been chosen as the end date for this book is that there is a popular misconception that derivatives trading actually "began" at the CBOT. "The business of derivatives can be traced back to Chicago . . .": John Rothchild, "How the Game Began", *Time* (New York, Time, Inc., 11 April 1994), pp. 32-33.

Chapter 8. This chapter will examine the nineteenth century prior to the opening of the CBOT in 1848. The growth of the derivatives markets in the UK and the new United States will be examined. The establishment of commodity and derivatives exchanges in England and the USA will be discussed. Changes in English regulations and in the various laws and regulations of the new US states will be examined.

Chapter 9. This chapter will examine the development of the derivatives market from 1848 and look at their future regulatory prospects.

Chapter 10. This chapter will conclude the book with a comparative summary of the data about derivatives and their regulation which has been developed in previous chapters, and will draw conclusions about the implications of that legal history regarding derivatives trade and regulation.

1.3 DEFINITIONS OF DERIVATIVES

1.3.1 Judicial Definitions

The term “derivative instrument” (often shortened to “derivative”) has come into commercial use only recently. Apparently, market participants began to apply the term to futures and options in the early 1980s, but the first “legal” use of the term is found in the 1982 New York Federal Court case of *Am. Stock Exch. v. Commodity Futures Trading Commission*.¹⁶ In that case, Judge Weinfeld wrote:

“When exercised, options on physicals lead to the delivery of the physical commodity itself; thus they are ‘first derivative’ instruments but one step removed from the underlying commodity. Options on futures are ‘second derivative’ instruments which give rise only to delivery of a futures contract, a contractual undertaking which can be transferred to third parties to buy or sell a fixed amount and grade of a certain commodity on some specified date.”¹⁷

Later that same year, a decision of the US Seventh Circuit of Court Appeals called futures and options contracts written on interests in government-underwritten residential mortgages (GNMA certificates) “derivative instruments”.¹⁸ From then on, the term appears in US cases from time to

¹⁶. 528 F. Supp. 1145 (U.S.D.C. S.D.N.Y. 1982).

¹⁷. See note 16, above, 1148, fn. 15.

¹⁸. *Board of Trade of the City of Chicago v. SEC*, 677 F.2d 1137, 1139 (7th Cir., 1982).

time,¹⁹ but is not found in any reported English decision until October 1995.²⁰

1.3.2 Trade, Economics and Dictionary Definitions

A wider use of the term took somewhat longer. A prominent industry trade association, formerly called the International Swaps Dealers Association (ISDA), which now calls itself the “International Swaps and Derivatives Association”, issued a *User’s Guide* to its standard forms in 1987 which did not mention derivative instruments.²¹ General texts on economics are also silent. The 1989 edition of *An Introduction to Positive Economics* by Richard G. Lipsey, contains no reference to derivative instruments and neither does the 1995 edition of Paul Samuelson’s classic text.²² Specialised books from the late 1980s, such as *The Economics of Futures Markets*, by Jerome L. Stein, or *The Futures Game* by Teweles and Jones, contained no references to derivative instruments.²³

The Oxford English Dictionary (second edition),²⁴ contains no specifically commercial definition of “derivative” and no definition of “derivative instrument”. The only specific applications for the word “derivative” given are grammatical, mathematical, musical, chemical, and medical. This omission is not peculiar to England. The *Random House Dictionary of the English Language* (second edition, unabridged) also fails to give any commercial definition for the word “derivative”.²⁵ Even specialised economics diction-

19. See, for example, *Abrams v. Oppenheimer Govt. Secs., Inc.*, 589 F. Supp. 4, 8 (U.S.D.C. N.D. I.L.L. E.D. 1983), and *on appeal*, 737 F.2d 582, 592 (7th Cir., 1984); *Starkman v. Warner Communs., Inc.*, 671 F. Supp. 297, 304 (U.S.D.C. S.D.N.Y. 1987); *D & N Fin. Corp. v. RCM Ptnrs. L.P.*, 735 F. Supp. 1242, 1244 (U.S.D.C. Del., 1990); *In re County of Orange*, 183 Bankr. 594, 598 (US Bankruptcy Court, C.D. Cal., 1995); *Kidder Peabody & Co. v. Unigestion Intl., Ltd.*, 903 F. Supp. 479 (U.S.D.C. S.D.N.Y. 1995); *Procter & Gamble v. Bankers Trust Co.*, 1995 U.S. Dist. LEXIS 19528 (U.S.D.C. S.D. Ohio WD, 1995).

20. *Bankers Trust International PLC v. P.T. Dharmala Sakti Sejahtera et al.*, Queen’s Bench Division (Commercial Court) (Transcript), 19 October 1995. Use of the term checked by LEXIS search, 29 January 1996.

21. International Swap Dealers Association, Inc., *User’s Guide to the Standard Form Agreements: 1987 Edition* (New York, 1987).

22. Paul A. Samuelson and William D. Norhaus, *Economics* (15th international edn, New York, McGraw-Hill, 1995), pp. 743–789; and Richard G. Lipsey, *An Introduction to Positive Economics* (7th edn, London, Weidenfeld & Nicholson, 1989).

23. Jerome L. Stein, *The Economics of Futures Markets* (Oxford, Basil Blackwell, 1986); and Richard J. Teweles and Frank J. Jones, *The Futures Game* (2nd edn, New York, McGraw-Hill, 1987).

24. (Oxford, Oxford University Press, 1989), s.v. “derivative”.

25. (New York, Random House, 1966), s.v. “derivative”.