

# Orange Co. bankruptcy puts derivatives on national agenda

by Nancy Spannaus

It may be the equivalent of closing the barn door after the horse has escaped, but the national regulatory agencies and the U.S. Congress nonetheless feel compelled to belatedly either take, or threaten, further regulatory actions against the cancerous speculative bubble known as financial derivatives and some financial institutions which are now in deep trouble as a result.

The trigger for this whirl of activity was the Dec. 6 bankruptcy of Orange County, California which suffered billions in derivatives losses. The political fallout from the Orange County events is spreading day by day, as layoffs are announced and legal investigations are begun. The dramatic collapse of one of the wealthiest and most populous counties in the United States has also put a spotlight on the financial management of other localities, many of which are courting similar fates as a result of financial speculative practices.

Given the extent of the speculation, and the rotting out of the U.S. physical economy, there is actually no way to save the banking system through increased regulation. What will be required is a bankruptcy reorganization which writes off much of the bad debt, preserves the commitments to pensions, salaries, and other essentials of living standards, and then permits the generation of directed credit to restart productive employment through large, desperately needed infrastructure projects.

But the political spotlight on the crimes of the derivatives speculators should have the salutary effect of showing who actually has destroyed the U.S. economy.

## Bankers Trust in the barrel

In the week before Christmas, the news hit the U.S. financial pages that Bankers Trust, one of the top money center banks, had been fined \$10 million for defrauding Gibson Greetings, makers of greeting cards, in its derivatives operations. Monetarily, the fine was a slap on the wrist, since Bankers Trust could have faced much larger fines or even criminal charges.

The Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) were the federal agencies that went after Bankers Trust for violating the law, in particular for "misrepresentations and omissions" to Gibson on the size of its derivatives losses. The taped record

of Bankers Trust's lies completely indicted the company, which the record shows to have made a substantial amount of its total customer revenues from the "confused" Gibson.

The mildness of the enforcement action was the result of massive lobbying by what the *Wall Street Journal* called "top financial dealers." "I've never had the experience before of so many parts of the industry weighing in with comments about a potential enforcement action," said new CFTC chairman Mary Schapiro. "We were very cognizant of not wanting to disrupt the market or create any legal uncertainty," she said.

Schapiro, who just took over from Wendy Gramm (whose husband is Texas Sen. Phil Gramm), said that this was the first time since the CFTC exempted swaps (a type of derivative) from its regulation, that it had exercised its authority to prosecute fraud.

## Orange County goes sour

There have been numerous signs that fraud prosecutions could also be coming from the Orange County situation, where Merrill Lynch was the key institution involved in promoting the risky derivatives transactions that have, to date, lost the county about \$2 billion. The SEC has issued subpoenas for the records of top Orange County officials, with special reference to the relationship between the officials and Merrill Lynch.

California Gov. Pete Wilson (R) has also ordered state auditors to review the activities of Orange County's funds since June 30, 1994, and for the last three years.

Efforts by Orange County to prevent the sell-off of its securities, even in the face of the bankruptcy, have been unsuccessful. Despite the bankruptcy court action permitting the release of some funds for urgent payments, the county is in severe financial straits and the Board of Supervisors has ordered \$40.2 million in budget cuts over the next six months. This will include 700-1,000 layoffs. The largest union in the county has announced plans to sue to prevent the layoffs.

In the wake of Orange County's bankruptcy, there have been runs on other municipal funds, and warnings of potential blowouts in municipalities in Texas, Maine, Wisconsin, and Florida. Not surprisingly, Congress has announced it will hold hearings to probe municipal derivatives. The schedule includes:

- The Senate Banking Committee under Alfonse D'Amato (R-N.Y.) will hold hearings on Jan. 5-6 on municipalities' use of derivatives and "leveraging strategies."
- The House Commerce Committee's financial subcommittee under Jack Fields (R-Tex.) will hold hearings on Jan. 10 on the adequacy of municipal bond disclosure.
- The House Banking Committee under Jim Leach (R-Iowa) will hold hearings in mid-January on Orange County and the need for tighter regulation of derivatives. Leach said he will introduce on Jan. 4, a bill to repeal the so-called Tower Amendment, a 1975 law that bars regulators from requiring municipal issuers to register their bonds with the SEC, which corporate borrowers must now do.