TESTIMONY OF

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COMMODITY FUTURES TRADING COMMISSION

CONCERNING THE OVER-THE-COUNTER DERIVATIVES MARKET

BEFORE THE U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING AND FINANCIAL SERVICES

JULY 24, 1998

Mr. Chairman and Members of the Committee:

I. Introduction

I am pleased to represent the Commodity Futures Trading Commission ("CFTC" or "Commission") here today to testify concerning H.R. 4062, the "Financial Derivatives Supervisory Improvement Act of 1998," and the regulation of the over-the-counter ("OTC") derivatives market.

The Commission has significant concerns about H.R. 4062 and urges this Committee to consider it very carefully. H.R. 4062 would prevent the Commission from taking action in market or other emergencies arising in that portion of the OTC derivatives market within its statutory authority, would forbid the Commission from enforcing its existing laws and regulations relating to certain transactions in that market, and would bar the Commission from addressing new developments in that market. It would for the first time eliminate the independence of the Commission as a regulatory agency by subjecting its actions relating to the OTC derivatives market to prior approval by the Secretary of the Treasury. It would also legalize certain OTC futures contracts that have been forbidden by law since 1982. These profound changes in the law, having significant impact on long-standing regulation of the OTC derivatives market, should be thoroughly examined. Important public interests would be harmed by their adoption.

This legislative initiative was triggered by the Commission's decision to evaluate the continuing appropriateness of its own regulations regarding OTC derivatives in light of changes in the OTC derivatives market over the past five years. That decision was part of an ongoing Commission effort to review its regulations to determine whether they should be streamlined, modernized or revised to reduce unnecessary regulatory burdens. No emergency has been created by the Commission's review which would justify the profound legal changes in H.R 4062.

II. The OTC Derivatives Market

Derivative instruments are contracts whose value depends upon (or derives from) the value of one or more underlying reference rates, indexes or assets. The classes of underlying assets from which a derivative instrument may derive its value include physical commodities (e.g., agricultural products, metals, or petroleum), financial instruments (e.g., debt and interest rate instruments or equity securities), indexes (e.g., based on interest rates or securities prices), foreign currencies, or spreads between the value of such assets. Derivative contracts may be listed and traded on organized exchanges or privately negotiated between the parties. Derivatives executed off of an exchange or board of trade are referred to as over-the-counter ("OTC") derivatives.

OTC derivatives are similar in structure and purpose to exchange-traded futures and options. Like exchange-traded derivatives, OTC derivatives are used for risk shifting and speculation. End-users employ OTC derivatives to hedge risks from volatility in interest rates, foreign exchange rates, commodity prices, and equity prices, among other things. These instruments also are used to assume price risk in order to speculate on price changes. Participants in the OTC derivatives market include commercial corporations, insurance companies, mutual funds, pension funds, colleges and universities, governmental bodies, banks, other financial service providers, and individuals with significant assets.

A simple example will illustrate how exchange-traded and OTC derivatives operate in a similar fashion in order to achieve the same purpose. Consider a business that has issued a note with a variable rate of interest payable semiannually over a fixed time period. If the firm becomes concerned that interest rates might rise over the remaining life of the note and that it might therefore be paying higher rates, the firm may wish to consider ways in which it can transform its variable rate liability into a fixed rate liability.

One way of doing this would be for the firm to sell a series of exchange-traded Eurodollar futures contracts, each of which matured on or about one of the note's interest payment dates. Because the cost of a Eurodollar futures contract falls as interest rates rise, profits from the futures position could be used to cover the difference between market rates payable on the note and the fixed rate established by the firm's transaction on the futures exchange. Alternatively, the firm could enter into a swap agreement in the OTC derivatives market in which it paid a fixed interest rate and received a variable interest rate based on the market rate with payment dates corresponding to the interest payment dates of the note.

Either method would allow the firm to convert its variable rate exposure to a fixed rate that would not fluctuate with changes in the interest rate market. The firm might choose exchange-traded futures for reasons of liquidity and transparency. In addition, if the firm chose exchange-traded futures, the risk of counterparty default would be assumed by the exchange's clearinghouse, which serves as the counterparty to both buyer and seller in every exchange transaction. If the firm chose to enter a contract on the OTC market, it would have to bear that risk of counterparty default itself. On the other hand, the OTC market permits parties to negotiate greater customization of terms, which may be a significant consideration if the size of the firm's exposure, or the dates on which its payments become due, do not correspond to the standardized terms of exchange-traded contracts.

Use of OTC derivatives has grown at a rapid rate over the past few years. According to the most recent market survey by the International Swaps and Derivatives Association ("ISDA"), the notional value of new transactions reported by ISDA members in interest rate swaps, currency swaps, and interest rate options during the first half of 1997 increased 46% over the previous six-month period.(1) The notional value of outstanding contracts in these instruments was reportedly $28.733 trillion worldwide, up 12.9% from year-end 1996, 62.2% from year-end 1995, and 154.2% from year-end 1994.(2)

ISDA's 1996 market survey noted that there were 633,316 outstanding contracts in these instruments as of year-end 1996, an increase of 47% from year-end 1995, which in turn represented a 40.7% increase over year-end 1994.(3)

An October 1997 report by the General Accounting Office ("1997 GAO Report") suggests that the market value of OTC derivatives represents about 3 percent of the notional amount.(4)

Applying the 3 percent figure to the most recent ISDA notional value for contracts outstanding for the first half of 1997 indicates that the worldwide market value of these OTC derivatives transactions is over $860 billion.

The OTC derivatives market is substantially larger than the ISDA survey data indicate since the data are limited to transactions involving ISDA members only and to transactions in only three kinds of instruments among the many instruments being traded. With a growing market have come growing profits for OTC derivatives dealers. According to an industry publication, OTC derivatives trading revenues reached a record $2.35 billion during the first quarter of 1998, exceeding the previous record by $100 million.(5)

III. Commission Regulation of OTC Derivatives

The CFTC or its predecessor agency, the Commodity Exchange Authority, has regulated derivative instruments for almost three-quarters of a century. Its authority is contained in the Commodity Exchange Act ("CEA" or "Act"), which is the primary federal law governing regulation of derivative transactions. The CEA vests the CFTC with exclusive jurisdiction over futures and commodity option transactions whether they occur on an exchange or over the counter. The Act generally contemplates that, unless exempted, futures and commodity options are to be sold through Commission-regulated exchanges which provide the safeguards of open and competitive trading, a continuous market, price discovery and dissemination, and protection against counterparty risk. Thus, the Act and CFTC regulations establish a regulatory framework for exchange-trading of futures and options and provide for Commission oversight of intermediaries engaging in such transactions on behalf of customers.

Through its regulation of derivative instruments, the CFTC attempts to assure that: (i) prices are established in an open, competitive and transparent manner free from price manipulation; (ii) the financial integrity of the markets is maintained; and (iii) customers are protected from fraud and other abusive practices. The Commission accomplishes these goals through its surveillance of the markets; its establishment of regulations governing, among other things, minimum capital requirements for market intermediaries, segregation of customer funds, risk disclosure for customers, and recordkeeping and reporting by commodity professionals; its oversight of self-regulatory organizations; and when necessary, emergency intervention or enforcement action.

Transactions in OTC futures and options are generally prohibited under the Act unless explicitly excluded or exempted from the exchange-trading requirement of the CEA. The Commission's enforcement docket has historically included numerous proceedings against persons trading in OTC derivatives that were outside the scope of any exemption or exclusion.(6)

For example, the Commission currently has four pending actions involving hedge-to-arrive contracts charging that the transactions constituted illegal OTC futures or options contracts. Similarly, its many cases against bucket shops are based on the fact that such operations sell derivatives off a regulated exchange and are also specifically prohibited by Section 4b of the Act.

The CEA specifically excludes certain types of OTC derivatives from the requirements of the Act. The so-called Treasury Amendment to the CEA provides that the CEA does not apply to OTC transactions in foreign currencies, government securities and certain other financial instruments.(7)

Options on securities and options on securities indexes also are excluded from the Act and are subject to the jurisdiction of the Securities and Exchange Commission ("SEC").(8)

In addition, the Commission itself has exempted certain types of OTC derivative transactions from specified provisions of the CEA. For example, under Section 4c of the Act, the Commission has the authority to allow options to be traded over-the-counter under such terms and conditions as the Commission may prescribe. Pursuant to this authority, the Commission has by regulation exempted certain OTC options from most provisions of the Act pursuant to specified terms and conditions.[(9)]

The Futures Trading Practices Act of 1992 gave the Commission additional authority to exempt transactions from certain provisions of the Act, including the requirement in Section 4(a) of the Act that futures must be traded on exchanges. Section 4(c)(2) of the Act provides that the Commission may grant an exemption if the Commission determines that (i) the transaction would be entered into solely between defined "appropriate persons"; (ii) the transaction would not have a material adverse effect on the ability of the Commission or any regulated exchange to discharge its regulatory or self-regulatory duties under the Act; and (iii) the exemption would be consistent with the public interest and the purposes of the Act. Section 4(c)(5) explicitly authorizes the Commission to grant exemptions for swap agreements and hybrid instruments. The Commission may grant exemptions "either unconditionally or on stated terms or conditions."[(10)]

Thus, the Commission has been given the flexibility and authority to tailor its regulatory program to fit the changing realities of the marketplace and the changing needs of market participants.

Pursuant to Section 4(c), the Commission adopted regulations in 1993 exempting certain swap agreements and hybrid instruments from some -- but not all -- provisions of the Act subject to specified terms and conditions. Part 35 of the Commission's Regulations exempts certain swaps from provisions of the Act other than the antifraud provisions, the anti-manipulation provisions, and Section 2 (a)(1)(B). [(11)]

Thus, swaps exempted under Part 35 may be traded over the counter without violation of the CEA. To be eligible for exemptive treatment under Part 35, an agreement: (1) must be a swap agreement as defined in Rule 35.1(b)(1); (2) must be entered into solely between specified eligible swap participants; (3) must not be a part of a fungible class of agreements that are standardized as to their material economic terms; (4) must include as a material consideration in entering into the agreement the creditworthiness of a party with an obligation under the agreement; and (5) must not be entered into and traded on or through a multilateral transaction execution facility.

The criteria contained in the swaps exemption were designed to assure that exempted swap agreements meet the requirements set forth by Congress in Section 4(c) of the CEA and to "promote domestic and international market stability, reduce market and liquidity risks in financial markets, including those markets (such as futures exchanges) linked to the swap market and eliminate a potential source of systemic risk."[(12)]

The criteria restrict OTC swap transactions to bilateral, customized transactions between financially sophisticated persons or institutions. The Part 35 exemption does not extend to transactions that are subject to a clearing system where the credit risk of individual counterparties to each other is effectively eliminated, nor does it extend to transactions executed on exchanges.

Part 34 of the Commission's Regulations exempts certain hybrid instruments from specified provisions of the Act, including the exchange-trading requirement.[(13)]

Under the rules, a hybrid instrument is defined as a financial instrument that combines elements of an equity, debt or depository instrument with elements of a futures or option contract. Part 34 exempts hybrid instruments from most requirements of the CEA to the extent that they are predominantly securities or depository instruments and are regulated as such.[(14)]

As part of the 1992 legislation, Congress also directed the CFTC to conduct a study of OTC derivatives to determine the need, if any, for additional regulation.[(15)]

In requesting the study, Congress recognized that the Commission, based on its expertise in derivatives, was the appropriate body to study the issue. The Commission carried out its Congressional mandate to study the market in 1993 and concluded that no fundamental changes in the regulatory structure for OTC derivatives were necessary at that time.[(16)]

IV. Regulatory Issues Posed by the Evolving Marketplace

Five years have passed since the Commission adopted its Part 34 and Part 35 regulations and last studied the OTC derivatives market. Since that time, the OTC derivatives market has changed significantly. When Congress gave the Commission its Section 4(c) exemptive authority in 1992, the Conference Committee expressly stated that the provision would permit the Commission to review its exemptions to "respond to future developments."[(17)]

The CFTC strongly believes that, in order to carry out its statutory mandate responsibly, it must keep its regulatory system in tune with changes in the market it oversees. Failure to keep pace with the changing market would stifle the capacity of U.S. firms to meet global competitive challenges, would create a cloud of legal uncertainty over the applicability of outdated rules to new products and innovative transactions, and would erode the regulatory system's ability to protect customers and to preserve the financial integrity of that market.

Consistent with these responsibilities, the CFTC over the past 18 months has been engaged in a comprehensive regulatory reform effort designed to update, to modernize and to streamline its regulations and to eliminate undue regulatory burdens.[(18)]

The Commission's review of its regulatory system would be incomplete in an important respect if it did not address the Commission's rules regarding OTC derivatives.

As noted earlier, the five years since the adoption of the Part 34 and Part 35 rules have been characterized by dramatic growth in the volume and value of OTC derivative transactions. Furthermore, the structure of the OTC derivatives market has changed significantly, creating a potential divergence between the Commission's regulations and the realities of the marketplace. For example, since 1993 the proliferation of OTC instruments has resulted in broader participation in the swaps market, encompassing new end-users of varying degrees of sophistication. This evolution in the market requires the Commission to evaluate whether it should broaden the definition of eligible swaps participants contained in its current rule and whether recordkeeping, sales practice, or other protections may now be appropriate. I cannot overemphasize that the Commission has not formulated any views, tentative or otherwise, on these questions. It simply is exercising its responsibility to make inquiry.

The swaps market also has experienced a proliferation of new products and proposed new trading systems. While the Part 35 exemption does not extend to swap agreements that are part of a fungible class of agreements, market information indicates that some swap agreements have become increasingly standardized, indicating a need to consider broadening the exemption under appropriate terms and conditions. Furthermore, the swaps exemption does not permit clearing of swaps or trading of them through multilateral transaction execution facilities, but developments in the marketplace have indicated a significant demand for both. For example, the London Clearing House recently filed a petition with the Commission for an exemption under Section 4(c) of the CEA to provide swap clearing services, and other organizations have indicated that they are developing similar facilities.[(19)]

Swaps clearing and execution facilities pose regulatory issues concerning systemic risk and price discovery that are not involved in privately negotiated, bilateral off-exchange swaps transactions. Any consideration of permitting clearing and execution facilities must also take into account the need to promote even-handed regulation and fair competition between any such new facilities and existing futures and option exchanges.

An additional concern is the legal uncertainty that may result from trading in OTC derivative instruments that do not comply with the terms and conditions of the current swaps exemption. To the extent that such instruments are futures or options and are not subject to another exemption in the Act, they would violate the CEA. Moreover, Section 12(e)(2)(A) of the Act was enacted in order to "provide legal certainty under . . . state gaming and bucket shop laws for transactions covered by the terms of an exemption" by preempting the application of such state laws.(20)

OTC derivative instruments that are outside the Commission's exemptions are also outside the protective umbrella of that preemption and may be deemed illegal under state law.

Another factor suggesting a need to request information about the OTC derivatives market arises from the large, well-publicized financial losses in the OTC derivatives market since the 1993 exemptions were adopted. While OTC derivatives serve important economic functions, these products, like all complex financial instruments, can present significant risks if misused or misunderstood. The 1997 GAO Report, entitled *OTC Derivatives: Additional Oversight Could Reduce Costly Sales Practice Disputes*, chronicles 360 end-user losses, of which 58% reportedly involved sales practice concerns.(21)

Major OTC derivatives losses relating to the recent instability in Asian financial markets are currently being reported, and more may be anticipated. According to a recent press report, J.P. Morgan "last year declared it had $659 million in nonperforming assets, 90% of which were defaults from Asian derivative counterparties."(22)

The same article states that Chase Manhattan "saw its 'nonperforming' assets in Asia triple in the first three months of 1998, to $243 million, due in part to derivatives."(23)

Concerns have also been raised regarding the potential effect of derivatives losses on the investing public(24) and on the financial system as a whole. As Alan Greenspan, the Chairman of the Board of Governors of the Federal Reserve System, stated on May 7, 1998:
the major expansion of the over-the-counter derivatives market has occurred in [a] period of unparalleled prosperity. . . [in] which losses generally, in the financial system, have been remarkably small . . . And as a consequence of that, I don't think that one will fully understand or know how vulnerable that whole structure is until we have it really tested. And eventually that's going to happen.(25)

Allegations of serious sales practice abuses by OTC derivatives dealers have been made in recent years in cases involving major losses by derivatives end-users. For example, an affiliate of Bankers Trust was charged with fraud in the sale of OTC derivatives in some well publicized cases involving Proctor and Gamble, Gibson Greeting Cards, and other large entities.(26)

Likewise, Merrill Lynch recently agreed to pay $400 million to Orange County, California to settle claims involving sales of derivatives that caused Orange County's bankruptcy and is reportedly in settlement negotiations with the Government of Belgium relating to its loss of $1.2 billion in derivatives trading. Furthermore, the 1997 GAO Report recommended that the SEC and the CFTC examine the experience of the members of the Derivatives Policy Group, an organization of five large OTC derivatives dealers, with respect to the voluntary sales practice standards they have adopted and also recommended a comprehensive review of sales practices and counterparty relationships in the OTC derivatives market.(27)

Losses resulting from misuse of OTC derivatives instruments or from sales practice abuses in the OTC derivatives market can affect many Americans -- many of us have interests in the corporations, mutual funds, pension funds, insurance companies, municipalities and other entities trading in these instruments. Obviously, regulation cannot and should not seek to eliminate market losses, but under the circumstances it is appropriate to request information regarding industry practices to assess whether they merit a regulatory response.

In light of these sales practice issues and the rapid development and evolution of the market, federal financial agencies are reviewing and revising their regulatory requirements regarding OTC derivatives. For example, on April 23, 1998, the Office of Thrift Supervision of the Department of the Treasury proposed what it termed "a comprehensive revision" of its "outmoded regulations" in response to "the development of new financial derivative instruments."(28)

In addition, the SEC proposed rules in December 1997 that would create for the first time a comprehensive SEC regulatory regime for certain very large OTC derivatives dealers.(29)

Not surprisingly, the CFTC as the expert federal agency in derivatives transactions also is reviewing its existing regulations relating to OTC derivatives, as discussed below.

V. The Commission's Concept Release on OTC Derivatives

In order to examine whether its regulatory framework relating to OTC derivatives remains appropriate in light of market developments since that framework was first adopted, the Commission issued a Concept Release on OTC Derivatives on May 7, 1998.(30) (See Attachment 1.) The Concept Release seeks public comment on whether the Commission's current exemptions for swaps and hybrid instruments remain appropriate as to, among other things, the definitions of eligible transactions and eligible participants and the prohibitions against fungible swaps, swaps clearing and multilateral swaps transaction execution facilities. It asks whether the current prohibitions on fraud and manipulation are sufficient to protect the public or whether the Commission should consider additional terms and conditions relating to registration, capital, internal controls, sales practices, recordkeeping or reporting. The Concept Release also asks whether, if additional oversight of those markets were required, such oversight would best be administered by the Commission itself or through self-regulatory organizations.

The Concept Release does not propose any modification of the Commission's regulations, nor does it presuppose that any modification is needed. It merely asks for information about current realities in the marketplace and views as to the appropriate Commission response, if any. The Commission wishes to draw on the knowledge and expertise of a broad spectrum of interested parties, including OTC derivatives dealers, end-users of derivatives, futures and option exchanges, other regulatory authorities, and academicians. The Commission would also welcome the comments of the members of this Committee and their constituents.

In issuing the Concept Release, the Commission has no preconceived result in mind. The Commission is open to evidence in support of broadening its exemptions, evidence indicating a need for additional safeguards and evidence for maintaining the status quo. Serious consideration will be given to the views of all interested persons as well as the Commission's own research and analysis. In the event that the Commission believes that proposed regulatory changes might enhance the competitiveness of the OTC derivatives market or provide necessary regulatory safeguards, such proposed changes would first be published for additional public comment before any final rules would be considered for adoption. Moreover, changes which impose new regulatory obligations or restrictions, if any, would be applied prospectively only.

The Concept Release explicitly states that it does not in any way alter the current status of any instrument or transaction under the CEA. All currently applicable exemptions, interpretations, and policy statements issued by the Commission regarding OTC derivatives products remain in effect and may be relied upon by market participants.

Concerns have been expressed about the Concept Release. Many of the concerns reflect a lack of understanding as to the nature and purpose of the Concept Release or a desire to avoid government oversight. Indeed, arguments have been made that OTC derivatives do not need government regulation or oversight of any kind. These arguments ignore that the OTC derivatives market is already subject to regulation by the Commission through the CEA's prohibition of OTC futures and options that are not exempted from the exchange-trading requirement, through the terms and conditions of the Commission's exemptions and through the Commission's fraud and manipulation prohibitions. The Commission agrees that unduly burdensome or duplicative regulation of the OTC derivatives market would not be in the public interest. However, it is the Commission's statutory mandate to oversee and safeguard the derivatives market, where billions of dollars of Americans are at risk.

Additionally, there have been unsupported claims that the Concept Release has created concerns about legal certainty that have disrupted the OTC derivatives market and driven business offshore. The Commission has yet to be provided with any empirical evidence that the Concept Release has caused disruption in the market. Commission staff has looked for signs of disruption and has not found any. The Commission does not believe that this robust, multi-trillion dollar market is so fragile that mere governmental examination of it will cause dislocation. Rather, in the Commission's view, the market will benefit from assuring that government regulations do not ignore developments and innovations in the marketplace. Moreover, as the Commission was careful to point out in the Concept Release, the Concept Release does not in any way alter the current legal status of any instrument.

Some argue that, having adopted exemptions for certain OTC derivatives transactions in 1993, the Commission cannot now update those exemptions to reflect the changes in the marketplace. This argument is flatly inconsistent with the intent of Congress in passing the Futures Trading Practices Act of 1992, during which the House and Senate Conference Committee noted:

[T]he Conferees intend for the general exemptive authority. . . to allow the [CFTC] to respond to future developments in the marketplace to avoid disruption and promote responsible economic and financial innovation, with due regard for the continued viability of the marketplace and considerations related to systemic risk in financial markets.(31)

As the President's Working Group on Financial Markets ("President's Working Group") -- consisting of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the SEC and the Chairperson of the CFTC -- wrote to Congress in 1994 concerning the CFTC's regulation of the OTC derivatives market,

[I]n order to fall within the safe harbor created by the Commodity Futures Trading Commission's (CFTC's) exemptions from the Commodity Exchange Act for swaps and other types of OTC derivatives transactions, all market participants must comply with the access and design restrictions contained in those exemptions. The CFTC's authority to reevaluate and impose conditions on exemptions for OTC derivative transactions can always be drawn upon if additional constraints on these instruments were determined to be warranted.(32)

Another claim is that the Commission lacks jurisdiction with respect to OTC derivative instruments. This position is incorrect, as the President's Working Group so clearly stated in 1994. As discussed above, the CFTC has always had jurisdiction over futures and options, whether traded on an exchange or over the counter. It is the nature of the instruments, and not where they are traded, that determines jurisdiction under the CEA.(33)

The Commission is cognizant of the fact that other federal regulatory authorities have responsibility for certain aspects of the OTC derivatives market. Some OTC derivative instruments are exempted under the CEA by the Treasury Amendment and the Shad-Johnson Accord and are regulated by the SEC, the banking regulators, or the Department of the Treasury. Moreover, the SEC and the banking regulators oversee some of the institutions participating in this market. Other OTC derivative instruments and other market participants are within the CFTC's exclusive authority. Thus, coordination and cooperation among the CFTC and these agencies are very important to avoid duplication and inconsistent regulation. In its Concept Release, the Commission stated that it "anticipates that, where other regulators have adequate programs or standards in place to address particular areas, the Commission would defer to those regulators in those areas."[(34)]

However, each federal financial regulator must act within its own statutory authority and comply with its own statutory mandate. On March 11, 1998, the Secretary of the Treasury, Robert Rubin, on behalf of the President's Working Group, wrote to the House Committee on Government Reform and Oversight that the President's Working Group would not conduct a study of sales practices and counterparty relationships in the OTC derivatives market, as the 1997 GAO Report had recommended. In explaining that refusal, he stated,

> The Working Group is designed as a mechanism to exchange information about financial market issues that cross traditional jurisdictional lines. It works through its constituent agencies with no independent budget. The authority of the Federal Government to collect sales practice information from federally regulated entities rests with the appropriate federal regulators.
>
> In recent years, the federal financial regulators that are members of the Working Group have taken a number of measures to improve dealers' sales practices for OTC derivatives . . . . Because the issue of the relationship of parties involves differing product classes, regulatory structures, and customer profiles, we believe there may not be a "one size fits all" solution. Therefore, we believe these processes should be allowed to evolve and that, at this time, there is no need for the Working Group as a whole to take additional measures. Each financial regulatory agency will continue to decide its appropriate role.[(35)]

The Commission believes that that position was correct in March 1998 and continues to be correct today, four months later. In issuing its Concept Release, the Commission has appropriately decided to address OTC derivative issues within its statutory authority and in conformity with its statutory mandate.

VI. The Commission's Concerns Regarding H.R. 4062

H.R. 4062 raises serious concerns. This proposed legislation would for the first time eliminate the status of the Commission as an independent federal regulatory agency by subjecting its actions to prior approval by the Secretary of the Treasury. It would severely limit the CFTC's ability to fulfill its oversight responsibilities with regard to OTC derivatives transactions within its statutory authority, would result in a substantial change in the CEA, and would potentially leave the American public without federal protection in the event of an emergency in the OTC derivatives market. No justification has been offered for these sweeping changes in OTC derivatives regulation.

Since its inception, the Commission has been an independent regulatory agency. The bill would eliminate the status of the CFTC as an independent regulatory agency by requiring that it obtain permission from the Secretary of the Treasury even to propose any regulatory or enforcement action involving OTC swaps or hybrid instruments. This change in the status of the Commission would profoundly impair its regulatory effectiveness. In creating the Commission, Congress found that the independence of the CFTC was essential for the agency to carry out its regulatory mission. As the Senate Committee on Agriculture and Forestry stated:

> The proper regulatory function of an agency which regulates futures trading is to assure that the market is free of manipulation and other practices which prevent the market from being a true reflection of supply and demand. Therefore, the Agency

> which regulates futures trading must have a neutral role on commodity prices. The Committee felt this neutral role can best be maintained by a completely independent agency.(36)

By requiring prior approval by the Secretary of the Treasury, Section 6(1) of the proposed legislation would effectively prohibit the CFTC from proposing or taking regulatory or enforcement actions relating to swaps or hybrid instruments. The Treasury Department has already taken the legally erroneous position that the Commission has no statutory authority over swaps in recent testimony before a House Agriculture Committee subcommittee.(37)

In light of that position, the Secretary of the Treasury certainly would not approve any request by the Commission to "propose or permit any rule, regulation or order, or issue any interpretative or policy statement" relating to swaps if he were granted the absolute discretion to refuse to do so, as proposed in H.R. 4062.(38) The resulting prohibition of CFTC action would continue for an extended, indefinite period of time until the enactment of legislation authorizing CFTC appropriations for any fiscal year after fiscal year 2000.

This provision could prevent the CFTC from adopting new regulations or policies to address a market crisis or financial emergency in the OTC derivatives market.(39) We have entered a period of substantial volatility in the world financial markets with recent enormous losses in derivatives reported in connection with Asian financial instability. If a crisis were to occur in the OTC derivatives market after enactment of the proposed legislation, the Commission would be unable to respond with any meaningful action: the Commission's hands would be tied. Since aspects of the OTC derivatives market are within the CFTC's exclusive jurisdiction, no other federal regulator would be able to react with emergency action in such spheres, creating a dangerous gap in regulation.

The provision could also prevent the Commission from enforcing its current fraud and manipulation prohibitions applicable to certain OTC swap transactions. Under Section 6(1) the CFTC would apparently be prohibited from conducting an enforcement investigation or issuing a cease-and-desist order in an enforcement case involving fraud or manipulation in swaps transactions eligible for exemption. Thus, for example, the Commission would not have been able to issue its cease-and-desist order to an affiliate of Bankers Trust in a case involving fraud in the sale of swaps. In the Matter of BT Securities Corp., CFTC Docket No. 95-3, 1994 WL 711224 (December 22, 1994). Similarly, the Commission recently issued an order finding that Sumitomo Corporation engaged in manipulation of the U.S. copper markets in violation of the CEA. The Commission imposed a cease-and-desist order and $150 million in civil penalties and restitution related to manipulative activity involving OTC derivatives transactions as well as transactions on the London Metal Exchange. That investigation is currently continuing with respect to individuals and institutions, but could not consider the use of swaps if the proposed legislation were passed.

In addition, the scope of Section 6(1) is ambiguous and likely would create significant legal uncertainty as to the Commission's legal authority. For example, the term "eligible for exemption under part 34 or 35" is unclear. It could be construed to prohibit CFTC action with regard to swap or hybrid instrument transactions as long as the instruments were theoretically eligible for the Part 34 or Part 35 exemption even though the instruments did not in fact comply with the terms and conditions set forth in those exemptions. Therefore, the Commission might no longer be able to enforce the terms and conditions of its current regulatory exemptions for swaps and hybrid instruments or to investigate possible violations of those terms and conditions. Thus, as a result of the proposed legislation, the Commission might be required to abandon ongoing investigations and inquiries.

In fact, Section 6(1) is sufficiently ambiguous that it might also be interpreted to prevent the Commission from amending its exemptions to reflect new developments in the marketplace. For example, the Commission's exemption for swaps currently prohibits swaps clearing and swaps exchange trading. The draft legislation might prevent the Commission from creating a regulatory framework for clearing and exchange trading of swaps despite increasing interest in establishing such operations and might require the Commission to withhold action on the pending London Clearing House petition to clear swaps and on other similar requests. Thus, either innovation in the marketplace would be stifled, or swaps clearing and exchange trading could develop in an unregulated manner in violation of the Commission's regulations and in direct competition with existing futures and option exchanges.

H.R. 4062 would make other fundamental and unwarranted changes in federal policy regarding the derivatives markets. For example, it would amend the Shad-Johnson Accord and retroactively legalize certain OTC futures contracts on non-exempt securities. The Shad-Johnson Accord clarified the respective jurisdictions of the SEC and CFTC and was codified in the CEA in 1982. Section 6(2) of H.R. 4062 would amend the Shad-Johnson Accord by "temporarily" eliminating the prohibitions in Section 2(a)(1)(B)(v) of the CEA against OTC futures contracts on nonexempt securities and on securities indexes that do not reflect a substantial segment of the market. Careful consideration by Congress of the public policy reasons underlying the long-standing statutory prohibition of such instruments and its proposed elimination is needed prior to acting on this provision.

While permitting OTC transactions in these instruments, Section 6(2) would continue the current prohibition on exchange trading in them. If OTC transactions in these instruments were to be permitted, Congress should certainly consider whether such instruments should also be permitted to be traded on the safer, more regulated exchange markets, as they currently are in a number of foreign countries. The U.S. futures exchanges would have a valid competitive interest in being able to trade these instruments under such circumstances.

The proposed legislation would also create a new federal agency, the Working Group on Financial Derivatives, and authorize it to review and to recommend changes to regulations governing both OTC and exchange-traded derivative markets -- including futures and commodity option exchanges regulated by the CFTC and securities option exchanges regulated by the SEC. This new body, which would be chaired by the Secretary of the Treasury, would have only one representative each from the CFTC and the SEC, but three members from the Department of the Treasury, two from the Federal Reserve System and one from the Federal Deposit Insurance Corporation. Thus, the proposed legislation would delegate review of federal law governing derivatives markets under the jurisdiction of the CFTC and the SEC to a body dominated by banking regulators with no expertise in derivatives market regulation.

In a June 10, 1998 hearing on the OTC derivatives market conducted by the Committee on Risk Management and Specialty Crops of the House Committee on Agriculture, agencies representing six of the eight members of the proposed new Working Group contemplated by H.R. 4062 -- the Treasury Department, the Federal Reserve Board and the SEC -- testified that they have already concluded that the CFTC should no longer retain its current statutory authority with regard to the OTC derivatives market and that the Commission's jurisdiction should be transferred to and divided among themselves. The new Working Group would become a platform for these agencies to implement this transfer of the CFTC's statutory authority.

Indeed, this transfer of authority would begin under the terms of the proposed legislation. While the bill would bar the CFTC from taking actions with regard to OTC derivative instruments within its jurisdiction, other federal regulators would remain free to go forward with their plans to issue new regulations relating to the OTC derivatives market. For example, the SEC would be free to finalize its proposed new regulatory scheme applicable to OTC derivatives dealers.[(40)]

Likewise, the Office of Thrift Supervision of the Department of the Treasury would be free to adopt its proposed comprehensive revision of regulations on derivatives.[(41)]

Such new regulatory action relating to the OTC derivatives market would destroy the regulatory status quo rather than preserve it. To impose a moratorium on CFTC action while allowing the other agencies to move forward would severely hinder -- not facilitate -- coordination and cooperation among federal financial regulators with respect to the OTC derivatives market.

Proponents of H.R. 4062 have argued that emergency legislation is needed to maintain the status quo in regulation of the OTC derivatives market. As discussed above, there is no emergency: the Commission's Concept Release has not disrupted the market or altered the legal status of any OTC derivative instruments. Furthermore, it is clear that the proposed legislation would profoundly alter the regulatory status quo, not maintain it.

In sum, H.R. 4062 would eviscerate key provisions of the CEA and facilitate transfer of the statutory authority in the CEA to other federal financial regulators whose expertise does not include derivatives market regulation. It purports to enhance legal certainty, but raises more legal questions than it resolves. Most importantly, it would create significant regulatory gaps by tieing the Commission's hands in addressing emergencies and wrongdoing in the market. If Congress wishes to take such actions, it should do so only after careful consideration of the dangers posed by H.R. 4062, not precipitously in response to cries of an emergency for which no evidence has been offered.

VII. Conclusion Mr. Chairman, I would like to thank you for this opportunity to present the views of the Commission, and I would be happy to answer any questions that the members of the Committee might have.

1. International Swaps and Derivatives Association, *Summary of Recent Market Survey Results,* ISDA Market Survey, available at http://www.isda.org.

2. *Id*.

3. *Id.*

4. General Accounting Office, GAO/GGD-98-5, *OTC Derivatives: Additional Oversight Could Reduce Costly Sales Practice Disputes* (1997) 3, n.6 ("1997 GAO Report"). The notional amount represents the amount upon which payments to the parties to a derivatives transaction are based and is the most commonly used measure of outstanding OTC derivatives transactions. Notional amounts generally overstate the amount at risk in such transactions.

5. *First Quarter Trading Revenues Soar to Record Levels,* Swaps Monitor, May 18, 1998, at 1.

6. *See, e.g., In the Matter of MG Refining and Marketing, Inc., et al.*, CFTC Docket No. 95-14, 1995 WL 447455 (filed Jul. 27, 1995);*Commodity Futures Trading Commission v. Noble Metals Intern., Inc.*, 67 F.3d 766 (9th Cir. 1995), *cert. denied sub nom. Schulze v. Commodity Futures Trading Commission*, 117 S.Ct. 64 (1996); *Commodity Futures Trading Commission v. American Metals Exchange Corp.*, 991 F.2d 71 (3d Cir. 1993); *Commodity Futures Trading Commission v. Co Petro Marketing Group, Inc*, 680 F.2d 573 (9th Cir. 1982).

7. The Treasury Amendment provides that nothing in the CEA shall be applicable to "transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade." Section 2(a)(1)(A)(ii) of the Act, 7 U.S.C. § 2(ii).

8. Section 2(a)(1)(B)(i), 7 U.S.C. § 2a (i). The SEC also has jurisdiction over foreign currency options, but only when they are traded on a national securities exchange. Section 4c(f) of the Act, 7 U.S.C. § 6c(f). The CFTC has jurisdiction over foreign currency options when traded on a board of trade. Sections 2(a)(1)(A)(ii)

and 4c(b) of the Act, 7 U.S.C. §§ 2(ii) and 6c(b).

9. The Commission has exempted trade options. Trade options are off-exchange commodity options offered and sold to commercial counterparties whose business involves the commodity (or by-products thereof) that is the subject of the transaction and who enter into the transactions for purposes related to that business. Commission Rule 32.4(a), adopted in 1976, permits the sale of OTC commodity options in circumstances in which the offeror "has a reasonable basis to believe that the option is offered to a producer, processor or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction" and that such commercial party is offered or enters into the transaction "solely for purposes related to its business as such." 17 C.F.R. § 32.4.

This trade option exemption does not extend to the basic agricultural commodities enumerated in the CEA. Due to concerns over historical abuses relating to agricultural options, they were subject to a statutory ban until 1982, and the Commission imposed a regulatory prohibition on OTC agricultural options thereafter. Recently, however, major changes in U.S. farm policy have created a growing demand in the marketplace for innovative agricultural risk management tools. Therefore, earlier this year the Commission implemented a pilot program to permit OTC agricultural trade options, subject to regulatory safeguards. 63 Fed. Reg. 18821 (Apr. 16, 1998).

10. Section 4(c)(1) of the Act, 7 U.S.C. § 6(c)(1).

11. 17 C.F.R. Part 35.

12. 58 Fed. Reg. 5587, 5588 (Jan. 22, 1993).

13. 17 C.F.R. Part 34.

14. Part 34 exempts hybrids, and those transacting in and/or providing advice or other services with respect to such hybrids, from all provisions of the CEA except Section 2(a)(1)(B) and thus permits OTC transactions in such hybrids, subject to the following requirements: (1) a requirement that the issuer must receive full payment of the hybrid's purchase price; (2) a prohibition on requiring additional out-of-pocket payments to the issuer during the hybrid's life or at its maturity; (3) a prohibition on marketing the instrument as a futures contract or commodity option; (4) a prohibition on settlement by delivery of an instrument specified as a delivery instrument in the rules of a designated contract market; (5) a requirement that the hybrid be initially sold or issued subject to federal or state securities or banking laws to persons permitted thereunder to purchase the instrument; and (6) a requirement that the sum of the values of the commodity-dependent components of a hybrid instrument be less than the value of the commodity-independent components.

15. *See* H.R. Conf. Rep. No. 102-978, 102d Cong., 2d Sess. 83 (1992)(Conference Report to accompany P.L. 102-546, the Futures Trading Act of 1992).

16. *See* CFTC, *OTC Derivatives Markets and Their Regulation* (1993).

17. *See* H.R. Conf. Rep. No. 102-978, 102d Cong., 2d Sess. 81 (1992).

18. *See, e.g.*, Revised Procedures for Commission Review and Approval of Applications for Contract Market Designation and of Exchange Rules Relating to Contract Terms and Conditions, 62 FR 10434 (Mar. 7, 1997); Final Rulemaking Concerning Contract Market Rule Review Procedures, 62 FR 10427 (Mar. 7, 1997); Contract Market Rule Review Procedures, 62 FR 17700 (Apr. 11, 1997); Electronic Filing of Disclosure Documents With the Commission, 62 FR 18265 (Apr. 15, 1997); Recordkeeping; Reports by Futures Commission Merchants, Clearing Members, Foreign Brokers, and Large Traders, 62 FR 24026 (May 2, 1997); Bunched Orders and Account Identification, 62 FR 25470 (May 9, 1997); Alternative Methods of Compliance With Requirements for Delivery and Retention of Monthly, Confirmation and Purchase-and-Sale

Statements, 62 FR 31507 (June 10, 1997); Interpretation Regarding Use of Electronic Media by Commodity Pool Operators and Commodity Trading Advisors for Delivery of Disclosure Documents and Other Materials, 62 FR 39104 (July 22, 1997); Securities Representing Investment of Customer Funds Held in Segregated Accounts by Futures Commission Merchants, 62 FR 42398 (Aug. 7, 1997); Concept Release on the Denomination of Customer Funds and the Location of Depositories, 62 FR 67841 (Dec. 30, 1997); Account Identification for Eligible Bunched Orders, 63 FR 695 (Jan. 7, 1998); Maintenance of Minimum Financial Requirements by Futures Commission Merchants and Introducing Brokers, 63 FR 2188 (Jan. 14, 1998); Requests for Exemptive, No-Action and Interpretative Letters, 63 FR 3285 (Jan. 22, 1998); Voting by Interested Members of Self-Regulatory Organization Governing Boards and Committees, 63 FR 3492 (Jan. 23, 1998); Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market, 63 FR 3708 (Jan. 26, 1998); Distribution of Risk Disclosure Statements by Futures Commission Merchants and Introducing Brokers, 63 FR 8566 (Feb. 20, 1998); Amendments to Minimum Financial Requirements for Futures Commission Merchants, *63 FR 12713 (Mar. 16, 1998); Two-Part Documents for Commodity Pools, 63 FR 15112 (Mar. 30, 1998); Rules of Practice; Proposed Amendments, 63 FR 16453 (Apr. 3, 1998); Trade Options on the Enumerated Agricultural Commodities, 63 FR 18821 (Apr. 16, 1998); Trading Hours, 63 FR 24142 (May 1, 1998); Recordkeeping, 63 FR 30668 (June 5, 1998); Elimination of Short Option Value Charge, 63 FR 32725 (June 16, 1998); Futures-Style Margining of Commodity Options, 63 FR 32726 (June 16, 1998); Changes in Trading Hours, 63 FR 33848 (June 22, 1998).*

19. The Commission has requested public comment on the London Clearing House petition. 63 FR 36657 (July 7, 1998).

20. H.R. Conf. Rep. No. 102-978, 102 Cong., 2d Sess. 80 (1992)

21. 1997 GAO Report at 10. See also Jerry Markham, Commodities Regulation: Fraud, Manipulation & Other Claims, § 27.05, at 27-30 27-34 (Supp. 1997) (presenting an extensive array of major OTC derivatives losses in 1994 alone).

22. Bernard Baumohl, The Banks' Nuclear Secrets, Time, May 25, 1998, at 50.

23. Id. at 46.

24. See, e.g., AARP/CFA/NASAA Background Report: The Five Biggest Problems 'Legitimate' Investing Poses for Older Investors (1995) (discussing "hidden derivatives in investment products touted as 'safe.")

25. Transcript for CNBC-TV "Power Lunch," May 7, 1998, provided by Video Monitoring Services of America, L.P.

26. See In the Matter of BT Securities Corp., CFTC Docket No. 95-3, 1994 WL 711224 (Dec. 22, 1994) (Gibson Greeting Cards); Procter and Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270 (S.D. Ohio 1996).

27. 1997 GAO Report at 137-38.

28. Financial Management Policies: Financial Derivatives, 63 Fed. Reg. 20252 (Apr. 23, 1998). See also Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities, 63 Fed. Reg. 20191 (Apr. 23, 1998).

29. OTC Derivatives Dealers, 62 Fed. Reg. 67940 (Dec. 30, 1997). The SEC has jurisdiction over OTC options on securities and options on securities indexes under the CEA. 7 U.S.C. § 2a(i). The GAO has reported that the SEC's jurisdiction extends to about 1.4% of the instruments in the OTC derivatives market. 1997 GAO Report at 42. Nonetheless, the SEC proposal purports to regulate trading in all OTC derivative instruments by OTC derivatives dealers operating under its proposed rule, including, for example, *commodity swaps and other instruments which are clearly not within the SEC's jurisdiction. The proposal also purports to permit trading in certain OTC derivative instruments which are not exempt under the CEA and the Commission's regulations.*

30. 63 Fed. Reg. 26114 (May 12, 1998).

31. H.R. Conf. Rep. No. 102-978, 102d Cong., 2d Sess. 81 (1992).

32. Views of the Working Group on Financial Markets on the Recommendations of the U.S. General Accounting Office Concerning Financial Derivatives at 3, attached to a letter dated July 18, 1994, from Lloyd Bentsen, Secretary of the Treasury, to John D. Dingell, Chairman, House Committee on Energy and Commerce.

33. As the Agriculture Committee stated in 1982 in approving the amendments to the CEA adopting the Shad-Johnson Accord on the respective jurisdictions of the SEC and the CFTC:

The committee has long recognized and accepted the inherent differences between the futures industry and the securities industry and endorses the concept of separate regulation. Basically, the CFTC will retain its traditional role of regulating markets and instruments that serve a hedging and price discovery function while the SEC will regulate markets and instruments with an underlying investment purpose.

H.R. Rep. No. 97-565, Part 1, 97th Cong., 2d Sess. 40 (1982) (House of Representatives Committee on Agriculture, Report To Accompany H.R. 5447, the Futures Trading Act of 1982).

34. 63 Fed. Reg. 26119-20 (May 12, 1998).

35. Letter dated March 11, 1998, from Robert Rubin, Secretary of the Treasury, to Dan Burton, Chairman, House Committee on Government Reform and Oversight.

36. S. Rep. No. 93-1131, 93d Cong., 2d Sess., 21 (1974)(Report on the Commodity Futures Trading Commission Act of 1974).

37. See Statement of John D. Hawke, Jr., Undersecretary for Domestic Finance, United States Department of the Treasury, before the Subcommittee on Risk Management and Specialty Crops of the House Committee on Agriculture, 1998 WL 12761017 (June 10, 1998). This position is in direct contravention of the view expressed by Secretary of the Treasury Lloyd Bentsen in 1994.

38. Even if the Secretary of the Treasury were not predisposed to deny approval of any proposal or action, the requirement that the CFTC submit its enforcement and regulatory actions to the Department of the Treasury for review and approval could lead to extensive delays in Commission action. The Commission would be required to share confidential information with another agency before an action could be brought before a judicial body. Such a system potentially would expose enforcement or regulatory decisions by the Commission to lobbying before the Treasury Department by persons potentially affected by the action. In addition, a decision by the Secretary to permit CFTC action might constitute final agency action subject to challenge in the courts, creating additional delays or grounds for challenging the CFTC's enforcement and regulatory actions.

39. While Section 6(1) purports to be limited to those swaps and hybrid instruments to which a depository institution or a securities broker-dealer is a party, it would have the sweeping effect of preventing any regulation or policy of general applicability because of the participation of such entities in the OTC derivatives market. It would also prevent enforcement of the law as to such entities while permitting enforcement against all other swaps market participants. Thus, Section 6(1) could raise significant issues *under the Due Process Clause of the Fifth Amendment to the U.S. Constitution by mandating disparate treatment of similarly situated market participants.*

40. See OTC Derivatives Dealers, 62 Fed. Reg. 67940 (Dec. 30, 1997).

41. See Financial Management Policies: Financial Derivatives, 63 Fed. Reg. 20252 (Apr. 23, 1998).