

*U.S. house of Representatives
Committee on Commerce
Room 2125, Rayburn house Office Building
Washington, DC 20515-6115*

March 13, 1995

The Honorable Arthur Levitt
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Levitt:

We are writing to acknowledge receipt of the report, "Framework For Voluntary Oversight," of the Derivatives Policy Group (DPG) which was convened last August to assist you in developing a framework for enhanced oversight of certain over-the-counter (OTC) derivatives activities.¹

We commend the firms comprising the DPG, as well as the Members and staff of your agency and of the Commodity Futures Trading Commission (CFTC), for the hard work and leadership that it took to accomplish this meaningful step. But we also agree with the proposition that this is an ongoing process and that more remains to be done.

Accordingly, pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, we are writing to request your analysis of and views on the DPG's report, including the extent to which it is responsive to the concerns raised in the August 10 letter cited above and the May 1994 report of the U.S. General Accounting Office.² Please explain how you and the DPG anticipate that the framework will be enforced in the event of noncompliance. Your report should also include responses to the following specific points:

¹ See, letter from the Honorable John D. Dingell, Chairman, U.S. House Committee on Energy and Commerce, to the Honorable Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, August 10, 1994, and response letter from the Honorable Arthur Levitt to the Honorable John D. Dingell, August 31, 1994, concerning the development of an oversight framework for unregulated derivatives dealers affiliated with U.S. securities firms.

² See, Financial Derivatives: Actions Needed to Protect the Financial System (GAO/GGD-94-133, May 18, 1994).

Management Controls. This component of the framework contains voluntary standards for internal management controls for monitoring and measuring the various risks to which a firm may be exposed as a result of dealings in OTC derivative products. It includes an external audit and verification process (Para. IV, p. 22). Please explain how the verification system will work. In the wake of the Barings PLC debacle, the development and maintenance of prudent risk management practices takes on heightened importance.

Enhanced Reporting. This component of the framework calls for the periodic submission to the SEC and the CFTC of a series of new quantitative reports covering credit risk exposures and related information associated with OTC derivatives activities. This is probably the strongest and best of the components. Please comment on the scope of the definition of “OTC derivative products” (pp. 23-24), and the nondisclosure of notional amounts.

Evaluation of Risk in Relation to Capital. This component sets forth methodologies for estimating the market and credit risk exposures arising from OTC derivatives activities to assist the SEC and CFTC in evaluating those risks and other relevant factors in relation to capital. The primary methodology used for this purpose will be estimates of “capital at risk” generated by the firms’ proprietary quantitative models. All such models used for this purpose will be subject to certain common minimum standards as well as audit and verification procedures. These estimates of capital at risk and certain other information, including the results of specified stress tests, will be submitted to the SEC and CFTC on a periodic basis.

Please comment on the following aspects and their impact: the appropriateness of using proprietary models, the adequacy of the shocks included in the stress tests, and the definition of capital at risk.

Counterparty Relationships. This component of the framework consists of guidelines for professional intermediaries with respect to their relationships with nonprofessional counterparties in connection with OTC derivatives transactions, *i.e.*, in other words, sales practices.

This is the most problematic and disappointing component of the framework. While the generic disclosure and account opening procedures appear to be pretty good, most of the guidelines fall far short of ensuring what we believe to be best practices at the best firms and, in some instances, are inconsistent with the undertakings in the Policy Overview.

For example, the Policy Overview at page 9 plainly states: “the firms represented on the DPG have agreed to adopt the practice of providing new nonprofessional counterparties with a written statement identifying the principal risks associated with OTC derivatives activities and clarifying the nature of the relationship between the parties.” However, the framework (Para. II, B., p. 37) merely suggests that a professional intermediary “should consider providing” that disclosure. Which is it? Perhaps even more curious is the suggestion (Para. II, G., p. 38) that a professional intermediary that undertakes to provide scenario or sensitivity analyses or other calculations “should make a good faith effort to perform those calculations accurately.” Our

question is: under what circumstances would the firms ever want these calculations to be done inaccurately?³

We are sensitive to the industry's legitimate concerns about operating in a global market and being subjected to conflicting standards, but wishy-washy guidelines won't enhance the firms' protection from liability nor will they protect customers from abusive practices. Please provide us with your evaluation of the DPG counterparty-relationship guidelines and your suggestions for a balanced and effective sales practice framework.

Separately, we respectfully request that you include in any annual reports to Congress under section 23(b) of the Securities Exchange Act of 1934, submitted after implementation, either in whole or in part, of the framework, an evaluation of its operation and success in attaining its stated objectives during the preceding year, along with such recommendations as the Commission considers appropriate.

Thank you for your cooperation and attention to this request.

Sincerely,

JOHN D. DINGELL
RANKING MEMBER
COMMITTEE ON COMMERCE

EDWARD J. MARKEY
RANKING MEMBER
SUBCOMMITTEE ON TELECOMMUNI-
CATIONS AND FINANCE

cc: Mr. E. Gerald Corrigan
Mr. John G. Heiman

³ See, for example, SEC Order Instituting Proceedings In the Matter of BT Securities Corporation, Securities Act Release No. 7124 (December 22, 1994).