

## COUNCIL OF ECONOMIC ADVISERS

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**Date:** October 27, 1999  
**To:** Martin Baily  
**From:** John Williams  
**Subject:** PWGFM Report on OTC Derivatives

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A final draft of the report "Over-the-Counter Derivatives Markets and the Commodity Exchange Act" by the President's Working Group on Financial Markets is attached. A Principal's Meeting is scheduled for Monday, November 1 to discuss this report. The plan is to publish the report as soon as possible. Nearly all interagency differences regarding the report have been resolved or smoothed over.

### **Background**

The market in over-the-counter (OTC) derivatives has ballooned. Under current law, it is unclear whether the Commodity Exchange Act applies to OTC derivatives and whether electronic trading systems and clearing systems are allowed. Lack of legal certainty has hampered the development of new instruments and the utilization of electronic trading systems and the creation of clearing systems, which could improve market efficiency, competition, and transparency and reduce systemic risk.

### **Recommendations**

The report makes the following recommendations:

- Exclude bilateral financial transactions between sophisticated parties from the CEA
- Relax restrictions on swaps (allow plain vanilla, etc.)
- Allow own-account electronic trading systems for financial derivatives
- Allow regulated clearing systems for OTC derivatives
- Clarify language regarding "board of trade" in the 1974 Treasury Amendment to the CEA
- Clarify that Shad-Johnson Accord does not apply to exempted hybrid instruments
- Modify CEA to allow regulation of hybrid instruments by other agencies

Overall, the recommendations are based on the view that the OTC derivatives markets should be allowed to innovate grow without fear of legal uncertainty or increased regulatory burdens. The report does make allowance for the possible future need of regulation as the market evolves and problems arise. The question as to who would regulate this market if the need arises is left open.