

TESTIMONY OF
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U.S. SECURITIES AND EXCHANGE COMMISSION
REGARDING THE REGULATION OF THE
OVER-THE-COUNTER DERIVATIVES MARKET
AND HYBRID INSTRUMENTS
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I appreciate the opportunity to testify on behalf of the Securities and Exchange Commission ("SEC" or "Commission") regarding its views on issues relating to the federal regulation of transactions involving over-the-counter ("OTC") derivatives and hybrid instruments. These issues involve significant questions of public policy that require the attention of Congress, members of the financial regulatory community, and interested industry participants.

Benefits of OTC Derivative Instruments

It is widely recognized that OTC derivative instruments are important financial management tools that, in many respects, reflect the unique strength and innovation of American capital markets. In fact, U.S. markets and market professionals have been the global leaders in derivatives technology and development.

OTC derivative instruments provide significant benefits to corporations, financial institutions, and institutional investors by allowing them to manage risks associated with their business activities or their financial assets. These instruments, for example, can be used by corporations and local governments to lower funding costs, or by multinational corporations to reduce exposure to fluctuating exchange rates. Because of the range of benefits these products offer, the OTC derivatives market has grown significantly during the past two decades.

The growth in activity involving this market has come, in part, as a result of the careful approach to regulation taken by Congress and by U.S. financial regulators. That approach has focused on promoting legal certainty for OTC derivative transactions and encouraging the development of sound industry practices.¹ That approach has also relied on building consensus among U.S. financial regulators through their participation in the President's Working Group on Financial Markets.

Concerns Regarding the CFTC Concept Release on OTC Derivatives

The recent concept release on OTC derivative instruments issued by the Commodity Futures Trading Commission ("CFTC") represents a significant departure from the careful approach taken by the SEC and other regulators to the OTC derivatives market.² In its concept release, the CFTC raises the possibility of applying a comprehensive regulatory regime to transactions involving swaps and hybrids as a condition for exempting such products from the requirements of the Commodity Exchange Act ("CEA"). Such a regulatory regime would necessarily be based on the CFTC's conclusion that swaps and hybrids are futures contracts or commodity options and, as such, are subject to CFTC jurisdiction under the CEA.

I joined the other members of the President's Working Group -- Treasury Secretary Rubin and Chairman Greenspan of the Federal Reserve Board -- in objecting to the issuance of the CFTC's concept release, citing grave concerns about the possible consequences of the

¹ See, e.g., Derivatives Policy Group, *Framework for Voluntary Oversight* (Mar. 1995). The Derivatives Policy Group was comprised of principals representing six major U.S. securities firms, specifically, CS First Boston, Goldman Sachs, Morgan Stanley, Merrill Lynch, Salomon Brothers, and Lehman Brothers.

² Commodity Futures Trading Commission, *Concept Release on Over-the-Counter Derivatives*, 63 FR 26114 (May 12, 1998).

CFTC's action.³ In particular, these concerns focus on the risk that the CFTC's action may increase the legal uncertainty concerning swaps and other OTC derivative instruments and, thus, destabilize what has become a significant global financial market. Uncertainty created by the CFTC's concept release and concerns about the imposition of new regulatory costs also may stifle innovation and push transactions offshore.

Any consideration of the issues facing the OTC derivatives market, such as legal certainty, the concerns of industry participants, and the role of U.S. financial regulators, must begin with an examination of how this market has evolved and which products are involved in the bilateral transactions conducted between market participants. A convincing argument has not been made that developments in the OTC derivatives market since 1994 -- when the members of the Working Group last testified before Congress on this market -- or since 1995 -- when the SEC and CFTC worked with the Derivatives Policy Group to develop a framework for voluntary oversight of OTC derivatives -- merit the CFTC's consideration of a vast, new scheme to regulate this market. Indeed, questions relating to what kind of regulation, if any, is appropriate for this market are ones that should not be addressed by an agency acting under a statute intended to govern only exchange trading in futures and commodity options.

Swaps

In its concept release, the CFTC sets out a broad regulatory agenda for regulating the OTC derivatives market and implies that the CFTC has jurisdiction over this market. We

³ Joint Statement by Treasury Secretary Robert E. Rubin, Federal Reserve Board Chairman Alan Greenspan and Securities and Exchange Commission Chairman Arthur Levitt, dated May 7, 1998.

disagree with the CFTC's approach. First, this approach necessarily involves examining the extent to which swaps may be futures subject to regulation under the CEA. On this issue the SEC has been clear -- traditional swaps that are not traded through a multilateral transaction execution facility are not futures and are not subject to regulation under the CEA.⁴ This view is shared overwhelmingly by the industry.

Second, as Secretary Rubin, Chairman Greenspan, and I suggested in our joint statement, we have serious doubts as to the CFTC's authority to regulate OTC markets. The CEA provides for the regulation of exchange-traded futures, making off-exchange futures transactions illegal under the statute. Nowhere in the CEA has Congress articulated an intent that the CFTC regulate off-exchange markets, nor has Congress established standards for the protection of the public interest should the CFTC assert jurisdiction over these markets.

Moreover, the CEA should not be used as a foundation on which to build a system of regulation for the OTC derivatives market. Because of the difference in goals between exchange markets for futures and OTC derivatives markets, the CEA should be interpreted as providing for exclusive CFTC jurisdiction only over futures contracts that are traded on an exchange. For example, it is critically important to prevent manipulation of exchange markets that perform a price setting function. The OTC derivatives market does not set the price of underlying cash commodities. This difference should be acknowledged in the regulation of these two markets.

⁴ Letter dated Jan. 4, 1993 from Jonathan G. Katz, Secretary, SEC, to Jean A. Webb, Secretary, CFTC, commenting on CFTC proposed rules regarding the regulation of swaps and hybrid instruments.

Third, we disagree with any plan by the CFTC to regulate the OTC derivatives market through exemption. In enacting the Futures Trading Practices Act of 1992, Congress gave the CFTC broad exemptive, not regulatory, authority regarding OTC swap transactions.⁵ Congress granted this authority to the CFTC without making any determination regarding the status of swaps and other OTC derivative instruments under the CEA. We disagree with the potential exercise by the CFTC of its exemptive authority as a means to regulate areas that have not been determined by Congress to fall within the CFTC's authority. This is very different from the exercise by an agency of its exemptive authority to provide regulatory relief in circumstances where the agency has clear jurisdiction over the activities or products that are subject to the exemption.

Moreover, regardless of the characterization of these instruments under the CEA, both the plain language of the CEA and the legislative history indicate that Congress did not intend for the CFTC to use its exemptive powers to establish a new regulatory regime for the OTC derivatives market. Notably, Section 4(c) of the CEA places certain conditions on the exercise of the CFTC's exemptive authority. These conditions include the requirement that any exemption be in the public interest, that exemptions be limited to transactions that would be effected between persons meeting the definition of "appropriate persons," and that exempted transactions not have a material adverse effect on the ability of the CFTC or any contract market to discharge its regulatory or self-regulatory abilities under the CEA. Beyond these

⁵ P.L. No. 102-546; 106 Stat. 3590 (1992). Using the exemptive authority granted to it under the Futures Trading Practices Act of 1992, the CFTC promulgated rules under Part 35 of its regulations exempting certain swap transactions from the provisions of the CEA, other than provisions prohibiting fraud and manipulation. 17 C.F.R. Part 35.

general requirements, Congress did not direct the CFTC to impose substantial additional requirements as a condition for exercising its exemptive authority, choosing instead to allow the CFTC to either exempt transactions unconditionally or on stated terms or conditions.

Given the willingness of Congress to allow the CFTC to exempt transactions without imposing conditions beyond those contained in Section 4(c), it is unlikely that Congress anticipated that the CFTC would establish exemptive conditions that, in effect, would require compliance with a new, comprehensive regulatory scheme for conducting off-exchange transactions. In fact, Congress specifically reserved for itself issues of regulatory policy relating to the OTC derivatives market. As stated in the Conference Report for the Futures Trading Practices Act of 1992, the purpose of giving the CFTC broad exemptive powers was to provide "a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development [could] proceed in an effective and competitive manner."⁶ The objective was legal certainty for swaps, not expansive regulation of an evolving market.

Hybrids

The CFTC's concept release also raises significant concerns regarding the current exemption for hybrid instruments contained in the CFTC's Part 34 rules.⁷ Hybrid instruments are depository instruments or securities products, such as debt or equity securities, that have one or more commodity-dependent components with payment features similar to commodity futures or commodity option contracts. Under the CFTC's Part 34 rules, such instruments

⁶ H.R. Rep. No. 102-978, 102d Cong., 2d Sess. 81 (1992).

⁷ 17 C.F.R. Part 34.

may be exempt from regulation under the CEA if the sum of the commodity-dependent values of the commodity-dependent components of the instrument is less than the commodity-independent value of the commodity-independent component.

In its concept release, the CFTC indicates that some experienced practitioners have stated that the definition of hybrid instrument under the Part 34 rules is complex and difficult to understand and apply. We believe that the current definition is working well and that the mathematical computations required under the definition are generally well understood. However, if industry representatives believe that the Part 34 rules are difficult to apply, we would be interested in working thoughtfully with the industry, bank regulators, and the CFTC to address those concerns.

More generally, it seems the CFTC is proposing to substantially narrow the scope of the current hybrid exemption. In addition, the exemption's availability would depend on compliance with a scheme of regulation that would be implemented based on the CFTC's exercise of its exemptive authority. It is important to recognize that all hybrids are already regulated as banking or securities products. Where the commodity-dependent variables are not paramount, there is no need to add another layer of regulation under the CEA.

Concerns of Market Participants

The CFTC's suggestion that swaps and hybrid instruments might be futures or commodity options -- derivative products regulated under the CEA -- represents a significant departure from traditional views about the status of swaps and hybrids under the CEA. A conclusion to this effect would be of great concern to participants in the OTC derivatives market who have long considered the CFTC's current exemptions for swaps and hybrids to be

non-exclusive safe harbors from regulation under the CEA. Consistent with this view, market participants believe that a broader range of swaps and hybrids than those described in the exemptions -- such as products based on equity securities -- also are not subject to regulation under the CEA. If swaps and hybrids in general are considered to be futures or commodity options, as the CFTC suggests, concerns will be raised not only that the CFTC might restrict its existing exemptions, but also that contracts executed outside the terms of these exemptions might be deemed illegal off-exchange contracts in violation of the CEA. Fears regarding the legality of swaps and hybrid instruments could seriously disrupt the derivatives market.

The SEC's "Broker-Dealer Lite" Proposal

The SEC's OTC Derivatives Dealer, or "Broker-Dealer Lite," proposal is intended simply to reduce the regulatory burdens faced by broker-dealers that conduct an OTC derivatives business.⁸ Under the SEC's current regulations, firms that effect transactions in OTC derivative instruments that are securities (such as OTC options on government securities) must register as broker-dealers and comply with the SEC's capital and margin requirements. In some instances, these regulatory costs have resulted in firms dividing their activities, placing non-securities activities in separate, unregistered affiliates located in the United States, and conducting their securities activities abroad.

In proposing special rules for a limited class of broker-dealers, called "OTC derivatives dealers," the SEC recognized that, in some instances, fragmenting a firm's OTC derivatives business may hinder its ability to manage risk and compete for business. If adopted, the proposed rules would provide U.S. securities firms with greater flexibility in structuring their

⁸ Exchange Act Release No. 39454 (Dec. 17, 1997), 62 FR 67940 (Dec. 30, 1997).

OTC derivatives activities by allowing them to conduct transactions involving both securities and non-securities derivative products through one entity. It should be emphasized here that flexibility is the goal. The proposed rules would reduce, rather than increase, the regulatory impediments to doing business.

Registration as an OTC derivatives dealer would be a voluntary alternative to registration as a fully regulated broker-dealer under the SEC's current rules. Modified capital rules would be applied to these registered dealers, under which they would be allowed to use value-at-risk models for determining market risk charges. OTC derivatives dealers would also be subject to the more flexible margin provisions typically applied to banks. This would make it more economical for the OTC derivatives dealers to conduct transactions involving both securities and non-securities OTC derivative products in the same place. However, this entire structure would be optional, including the determination as to which, if any, instruments a dealer chose to place in the separate entity, along with its securities OTC derivative products.

The SEC's "Broker-Dealer Lite" proposal does not expand the SEC's jurisdiction, nor does the proposal claim that OTC derivative instruments generally are securities. Under the proposal, OTC derivatives dealers can opt to trade a wide range of derivative products; of these, the SEC can only regulate securities transactions engaged in by the OTC derivatives dealer. This does not represent any change in the exercise of the SEC's jurisdiction. Moreover, any activity involving futures transactions by an SEC regulated entity would remain subject to the CFTC's exclusive jurisdiction -- as is the case today.

In short, the SEC's proposal for OTC derivatives dealers is intended to promote market development and innovation and encourage dealers to keep business in the United States. It

also is, in effect, a laboratory in which the SEC can test the operation of new concepts, such as value-at-risk, in a controlled environment, before introducing them into its rules for all broker-dealers. The OTC derivatives market has grown substantially in recent years, and this growth is indicative of the strength and vitality of U.S. capital markets. In contrast, conclusions drawn from the CFTC's concept release raise concerns regarding legal uncertainty for OTC derivative instruments and the imposition of new regulatory costs. These concerns may stifle innovation or push transactions offshore.

Next Steps

The recent letter from Chairman Born agreeing to forego action until next year is a step in the right direction, but we believe it would be possible to go further by addressing the outstanding legal uncertainties created by the concept release. It would be more helpful if the letter clarified that most swaps are not appropriately regulated as futures -- the previous position of the CFTC -- and extended the period of standstill until the re-authorization of the CFTC. Alternatively, the temporary legislative request made by Secretary Rubin, Chairman Greenspan, and myself would provide Congress and the regulatory community adequate time to properly consider the important public policy issues raised by activities in this market.⁹ This request was not made lightly and could help prevent any perception that the U.S. regulatory system imposes an unreasonable amount of legal uncertainty on transactions in the OTC derivatives market, thereby avoiding litigation that could increase this uncertainty.

⁹ See Letter dated June 5, 1998 to The Honorable Newt Gingrich, Speaker, U.S. House of Representatives, from Robert E. Rubin, Secretary, Department of the Treasury, Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, and Arthur Levitt, Chairman, Securities and Exchange Commission.

In particular, the requested legislation would require the members of the President's Working Group to study the OTC derivatives market to evaluate whether any additional safeguards are warranted. The scope of the study would be OTC derivative instruments, including swap agreements, and hybrid instruments. Following completion of the study, the President's Working Group would develop recommendations, as may be appropriate, for changes in statutes, regulations, and policies to improve operation of this market and to enhance legal certainty for swap agreements and hybrid instruments. The legislation would require the President's Working Group to submit a report to Congress describing the study and setting forth any recommendations.

Because of the importance of legal certainty to market participants, the legislation would also maintain the regulatory status quo by imposing a temporary moratorium on the CFTC's ability to restrict its current exemptions for hybrid instruments and swap agreements. More specifically, the legislation would require that prior to the enactment of legislation reauthorizing the CFTC, the CFTC would not be permitted to promulgate any proposed or final rule, regulation, or order -- or issue any interpretive or policy statement -- restricting or regulating activity in any hybrid instrument or swap agreement currently eligible for exemption under the CFTC's regulations. The legislation would also provide legal certainty to derivatives based on non-exempt securities.

Conclusion

In short, the CFTC's concept release raises important policy questions that should not be addressed by the CFTC alone, but rather require the attention of Congress, members of the financial regulatory community, and interested industry participants. The OTC derivatives

market is a rapidly growing and extremely vital global market that crosses jurisdictional boundaries among the regulatory community. The legislative proposal put forward by Secretary Rubin, Chairman Greenspan, and me recognizes the need to protect the market from unreasonable and potentially harmful legal uncertainty, while also providing the time needed to allow the President's Working Group to study the issues raised by activities in the OTC derivatives market and to develop, as a group, appropriate recommendations to Congress.

The Commission appreciates the opportunity to offer its perspectives on the OTC derivatives market, and to re-emphasize its serious concerns with the CFTC's concept release and the damaging consequences that concept release could have on this market. The President's Working Group should be provided with the opportunity to carefully study the OTC derivatives market and to analyze the current regulatory structure. The Commission and its staff welcome any questions on these issues that the Committee may have, and look forward to continued discussions with Congress, the President's Working Group, and industry representatives on these important issues.