

**TESTIMONY OF LAWRENCE H. SUMMERS ON THE COMMODITY FUTURES
MODERNIZATION ACT TO THE SENATE AGRICULTURE AND BANKING
COMMITTEE
June 21, 2000**

Chairman Lugar, Chairman Gramm, Senator Harkin, and Senator Lugar, Members of this Committee, thank you for giving me the opportunity to discuss the Commodity Futures Modernization Act with you today. This legislation represents an important step in the modernization of the regulatory structure for the U.S. derivatives market. Let me also take this opportunity to commend Chairman Lugar and Chairman Gramm, for the leadership and interest you have both shown in this area.

The over-the-counter derivatives market is an important component of the American capital markets and a powerful symbol of the kind of innovation and technology that has made the American financial system as strong as it is today. Operating within a proper and appropriate framework of legal certainty, we believe that the benefits to the U.S. economy of OTC derivatives would continue to grow. For example:

- By helping businesses and financial institutions to hedge their risks more efficiently, derivatives enable them to pass on the benefits of lower costs to American consumers and businesses.
- By allowing for the transfer of unwanted risk, derivatives promote more efficient allocation of capital across the economy, increasing productivity.
- By providing better pricing information, derivatives can help promote greater liquidity and efficiency in the underlying cash markets.
- Finally, by enabling more sophisticated management of assets, including mortgages, consumer loans, and corporate debt, derivatives can help lower mortgage payments, insurance premiums, and other financing costs for American consumers and businesses.

Clearly, it is vital that we work together to provide a regulatory framework that will ensure the continuation of a healthy and well-functioning OTC derivatives market. While the current framework here in the U.S. remains outdated, markets overseas are developing in a legal and regulatory environment that allows greater efficiency and transparency.

Unless our laws and regulations relating to derivatives are modernized, we run the risk that innovation will be stifled by the absence of legal certainty, depriving the American economy of the benefits that the derivatives markets can provide, and hampering the efforts of our OTC and exchange-traded markets and businesses to compete globally.

Let me divide my remarks into four parts:

- First, our guiding principles for modernization of the U.S. legal and regulatory framework.

- Second, our overall response to S2697, the CFMA, with a particular focus on two specific aspects of the legislation.
- Third, why it is important that we prevent regulatory arbitrage and preserve the integrity of the underlying cash markets.
- And fourth, the need to enact the recommendations of the President's Working Group Report that deal with treatment of OTC derivatives in cases of bankruptcy.

I. Why we Must Modernize our Legal and Regulatory Framework for Derivatives.

As a result of concerns about the regulatory structure of U.S. derivatives, Congress requested that the President's Working Group study the OTC derivatives market and recommend what changes were required. The Working Group worked on the assumption that legislative action would be required within a timeframe appropriate to the growing importance of the OTC derivatives market – and taking into account this market's potential contribution to the efficient functioning of the American financial sector and to that of the economy as a whole.

The Working Group had four primary objectives for Legislation in this area.

- **To reduce systemic risk** in the OTC derivatives market by removing legal impediments to the development of clearing systems and ensuring that those systems are appropriately regulated.
- **To promote innovation** in the OTC derivatives market by providing legal certainty for OTC derivatives and electronic trading systems. This would strengthen the overall legal framework governing the OTC derivatives market that, in turn, would stimulate even greater competition, transparency, and efficiency and deliver stronger benefits to U.S. consumers and businesses.
- **To protect retail customers** by ensuring that appropriate regulations are in place to deter unfair practices in all markets in which they participate and by closing existing legal loopholes that allow unregulated entities to pursue such unfair practices.
- **To maintain U.S. competitiveness** by providing a modernized framework that will lead those engaged in the financial services industry to continue the operations of their businesses in the United States, and thereby assuring the continued leadership of our capital markets.

In addition, because the scope of the legislation being considered extends beyond the areas considered in detail by the Working Group, we would add a fifth important objective:

- **To protect the integrity of the markets** underlying the derivatives in question – in particular, the markets for securities.

We believe that our recommendations with respect to clearing and those designed to enhance transparency and legal certainty and to clarify the treatment of derivatives in the case of bankruptcy or insolvency can contribute to enhancing the stability of the system more broadly.

The challenge before these Committees and the Congress is to establish a regulatory regime that will strike a balance between allowing the economy to realize more fully the benefits of derivatives and, at the same time, ensuring the integrity of the underlying markets, providing appropriate protection for retail customers, and where possible, taking steps to mitigate systemic risk.

At the same time, we need to recall that the emergence of these markets has occurred during an era of unprecedented economic growth and prosperity. It is to be expected that in times of distress some participants in these markets, as in other financial markets, will be adversely affected. What needs to be protected, however, is the financial system as a whole, and not individual institutions.

We suggest a paradigm for legislation that recognizes that with the appropriate legal framework, the OTC derivatives markets can make a valuable contribution to the efficient functioning of the American capital markets, with benefits for both businesses and consumers. Under the existing regulatory framework, there is a risk that these benefits will not be fully realized.

II. Our Response to the Commodity Futures Modernization Act.

Mr. Chairman, in light of the Working Group's recommendations, we broadly support this bill and are committed to working with these Committees and Congress to facilitate the enactment of this important legislation.

Moreover, we believe it is crucial to move forward with legislation as soon as possible. In the absence of an updated legal and regulatory environment, needless systemic risk might jeopardize the broader vitality of the American capital markets. We also risk an erosion of competitiveness of American financial markets, with an increasing amount of business moving offshore to jurisdictions where the framework has kept up with the pace of change.

In that regard, we believe that this bill incorporates the recommendations of the Working Group with respect to OTC derivatives which, if enacted, would improve the competitiveness of the market by promoting greater legal certainty for these instruments and strengthening the transparency and efficiency of these markets.

However, the bill is more comprehensive than the Working Group's recommendations. It addresses two areas outside of the OTC derivatives markets on which the Working Group did not make specific recommendations with regard to legislation. These are regulatory relief for the futures exchanges, and the Shad-Johnson Accord on single-stock futures. I would like to discuss both of these areas later in the testimony.

We also have two primary concerns with this bill, related to specific provisions that we believe could have a detrimental effect on the integrity of the securities markets. Let me address each of these in turn.

First, certain provisions that exclude swaps and other derivative transactions based on securities from the Securities Laws.

The bill provides a broad exclusion from the securities laws for swaps based on securities. On careful consideration, we believe this approach gives rise to a number of problems:

- The CEA creates real questions about the enforceability of certain swaps if they can be legally defined as futures. This was the source of concerns over the CFTC's "Concept Release," and the impetus behind the Working Group's report. As applied to actual swap agreements, the provisions excluding swaps based on securities from the securities laws are unnecessary, because the securities laws do not give rise to the legal certainty concerns that exist under the Commodity Exchange Act.
- The bill [sections 22 and 23(c)-(k)] would exclude all "individually negotiated" transactions in securities from all of the securities laws. Although these provisions state that they provide "legal certainty to swap agreements," they could actually cut significant holes in the fabric of securities regulation.
- This bill contains a definition of "swap agreement" that includes transactions and instruments that clearly are securities transactions, including options, warrants, and the simple sale of stocks or bonds through an individually negotiated transaction.
- Even if the definition were limited to apply only to actual swap agreements, however, the provisions would still be objectionable. Instruments such as total rate of return swaps on a security, in which one party agrees to pay another party the returns associated with owning a given security, can be used as substitutes for securities. Accordingly, some provisions of the securities laws should be applied to swaps that reference securities.

As a result of the exclusion, we believe there would be a number of adverse consequences especially in regard to insider trading, fraud, and customer protection rules:

- A corporate insider with inside information could profit on the information through an "individually negotiated" transaction and escape punishment under the securities laws.
- An issuer of securities could sell them in "individually negotiated" private placements and not be subject to any federal securities law liability for making false or misleading statements.
- A broker that sold securities through "individually negotiated" transactions would not be subject to SEC oversight.

- By threatening the integrity of the securities markets, this has the potential to raise the cost of capital for American businesses.

These provisions pose a threat to the integrity of the securities markets. We strongly recommend that they be removed from this bill.

Second, certain provisions of the regulatory relief section that permit "exempt boards of trade".

The Treasury Department continues to support the view that it is appropriate to review, from time to time, existing regulatory structures to determine whether they continue to serve valid regulatory functions. Like the OTC markets, exchange trading of derivatives should not be subject to regulations that do not have a public policy justification.

The CFTC has recently released its regulatory relief proposal for public comment. We will be submitting a formal comment letter on this proposal in the near future. Broadly, we are supportive of the CFTC's efforts to provide appropriate regulatory relief to the futures exchanges, consistent with the public interest.

There may, however, be unforeseen consequences to *legislating* such regulatory relief. Once such provisions are written into law, the regulators will have no ability to review and amend them should subsequent market developments warrant change or should other problems arise. Again, we are supportive of appropriate regulatory relief for futures exchanges, but suggest that certain aspects of that relief may be more appropriately provided through administrative action.

In particular, we are concerned with the provisions in S.2697 regarding "exempt boards of trade." To encourage innovation, the Working Group recommended an exclusion from the Commodity Exchange Act for electronic trading systems that satisfy certain criteria. Although the bill contains provisions to enact this exclusion, it also contains a statutory exemption for certain electronic and physical trading facilities. These "exempt boards of trade" would remain subject to the CEA's "exclusive jurisdiction" clause, thereby precluding regulatory oversight by other agencies.

- The potential impact of this provision on the government securities market is of particular concern to the Treasury Department. In 1986, Congress passed the Government Securities Act to provide an appropriate regulatory framework for the government securities markets in direct response to a number of problems in the unregulated portion of this market. In 1993, in response to incidents of wrongdoing in Treasury auctions, Congress strengthened these laws to provide additional protection against market abuses.
- Under some interpretations, S. 2697 could allow futures on government securities to escape most of the provisions of the CEA that currently apply to them, but would block regulation under the Government Securities Act. In addition, securities market participants that are currently regulated under the Government Securities Act could potentially restructure themselves as exempt boards of trade to evade regulation under both statutes.

- This has the potential to undermine the laws that Congress put in place in recent years that were designed to uphold and strengthen the integrity of the government securities market. Any reduced confidence in the integrity of the government securities market could lead to higher financing costs for the Treasury and thus an increased burden on American taxpayers.

For these reasons, we strongly recommend that those provisions of the bill related to exempt boards of trade be removed, or amended to preclude the trading of securities-related products on those systems.

III. The Shad-Johnson Accord.

As I mentioned earlier, the bill also contains provisions regarding futures on non-exempt securities, an area where the Working Group made no specific recommendations. The members of the Working Group agreed that the current prohibition on single-stock futures could be repealed if issues about the integrity of the underlying securities markets and regulatory arbitrage are resolved. Our view remains unchanged.

The provisions contained in this bill regarding futures on non-exempt securities are a good starting point, although a number of issues remain unresolved. The bill addresses some of the customer protection and enforcement concerns identified by the CFTC, the SEC, and others as necessary conditions for repealing the prohibition on single-stock futures.

However, there are a number of concerns that the regulatory agencies consider important, but that have not been resolved in the legislation. We hope that the SEC and CFTC can provide specific comments on these issues in the near future so that they can be incorporated into this bill.

In addition, certain issues related to the harmonization of margin requirements will need to be clarified. While we do not see the need to establish margin requirements in statute, it will be important to establish margin levels that do not encourage regulatory arbitrage or lead to a substantial increase in leverage in our financial system.

While we have no objection to the introduction of single-stock futures, it is vitally important that the integrity of the underlying markets be preserved, and that these instruments not be used as a means to avoid the regulations of the cash markets. Therefore, we continue to be supportive of efforts by the SEC and CFTC to reach an agreement on a regulatory framework for these products that preserves the integrity of the underlying securities markets. In addition, we are supportive of actions taken by Congress to urge progress in these discussions.

However, if these issues cannot be resolved on a timely basis, we believe that it is important to move forward with legislation designed to clarify the legal certainty for OTC derivatives.

IV. The Importance of Bankruptcy Legislation.

Although not part of this bill, I would like to take this opportunity to strongly urge Congress to adopt the President's Working Group recommendations regarding the treatment of these instruments and certain other financial contracts in cases of bankruptcy or insolvency.

Rarely are there tangible steps the government can take that could have a meaningful impact on the mitigation of systemic risk. Enacting the recommendations of the Working Group designed to clarify the treatment of these instruments in bankruptcy is one of those steps.

By establishing a framework through which creditors and counterparties can work out a swift resolution in cases of bankruptcy or insolvency, enactment of these recommendations can serve to reduce the impact of the failure of any one institution on the stability of the system more broadly.

V. Conclusion