Securities Industry Association

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October 13, 1998

Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Over-the-Counter Derivatives Concept Release

Dear Ms. Webb:

The OTC Derivative Products Committee (the "Committee") of the Securities Industry Association (the "SIA")[1] submits this letter in response to the concept release approved for publication by the Commodity Futures Trading Commission (the "Commission" or "CFTC") on May 7, 1998 (the "Concept Release").[2] The Concept Release solicits comments as to whether the regulatory structure applicable to over-the-counter ("OTC") derivatives under the Commission's regulations should be modified in light of recent developments in the marketplace.

I. OVERVIEW

The Committee does not agree with the Commission's implicit premise that it has the statutory authority to impose a comprehensive regulatory regime for individually negotiated swaps and hybrids as contemplated by the Concept Release.

The Committee similarly does not believe that an agency concept release is in any event an appropriate forum in which to address the fundamental policy questions raised in the Concept Release. Congress is the appropriate body for considering fundamental issues such as whether or how classes of instruments should be regulated. It is the province of administrative agencies to implement these determinations in accordance with Congressional direction, and not to make them in Congress's stead.

Congress has given no such direction to the CFTC. Indeed, if anything, Congress has given an unambiguous and unequivocal contrary direction to the Commission. Congress has expressed a clear intention to initiate, on the basis of recommendations from a broad regulatory constituency, any reappraisal of regulatory policy regarding OTC derivatives. Accordingly, Congress is the only appropriate forum for determining whether it is necessary or appropriate to regulate swaps, or to alter the regulatory treatment of hybrid instruments. Given the potentially far-reaching impact any new regulation could have on the U.S. economy, Congress should be the locus of any such decision. In addition, and equally significantly, only Congress has the authority to bring the necessary degree of certainty to this area of the law without disrupting a broad range of activity that has proved beneficial to companies in all sectors of the U.S. economy.

Moreover, it is clear from the history, purpose and structure of the CEA that the CEA is not in any event an appropriate statutory framework for regulating individually negotiated swaps and hybrid instruments.

The Commission has cited numerous "market developments" in support of its initiative. The Committee does not believe that the market developments cited in the Concept Release, to the extent accurate, justified issuance of the Concept Release or would justify implementation of a new regulatory regime for swaps and hybrid instruments even if such implementation were within the CFTC's jurisdiction.

II. CONGRESS IS THE APPROPRIATE FORUM FOR THIS INQUIRY

Adoption, indeed consideration, of the regulatory measures described in the Concept Release implies a Commission determination that the covered swap transactions are futures contracts (or commodity options) under the Commodity Exchange Act (as amended, the "CEA"). The Committee disagrees with this fundamental premise of the Concept Release. In addition, it is clear from even the most cursory examination of the legislative record that Congress intended to reserve any such determination to itself. Relevant policy considerations also militate in favor of a ***congressional*** resolution of the legal uncertainties surrounding the status of OTC derivatives.

A. The Commission Lacks Jurisdiction to Determine Whether Swaps Should Be Regulated under the CEA; Economic Equivalence Is Not a Sufficient Basis for Regulating Swaps as Futures under the CEA.

The Committee finds it noteworthy that the Commission did not request comment as to whether, or to what extent, OTC derivatives are subject to the jurisdiction of the CFTC. Rather, the Concept Release simply assumes that the various regulatory measures it describes would fall within the CFTC's statutory authority, based on the premise that swap agreements are futures contracts or commodity options under the CEA. Although the Concept Release contains no affirmative statement to that effect, the Commission's implementation of the measures described in the Concept Release would result in a comprehensive regulatory regime for swap transactions that currently satisfy the Commission's exemption for swap agreements under Part 35 of the Commission's regulations (the "Swap Exemption").

Neither the term "futures contract" nor the phrase "contract of sale of a commodity for future delivery" is expressly defined in the CEA. Section 3 of the CEA, however, provides some guidance as to the scope of transactions that Congress intended to regulate as futures contracts under the CEA. Section 3 provides, in pertinent part, that:

> Transactions in commodities involving the sale thereof for future delivery ***as commonly conducted on boards of trade and known as "futures"*** are affected with a national public interest. **3**

The expression "as commonly conducted on boards of trade" suggests that the scope of activity that Congress intended to regulate could include activity that does not take place ***on*** a board of trade, provided that the conduct of such transactions is sufficiently similar to the conduct of futures contracts on boards of trade. To delineate the class of transactions that Congress sought to regulate, therefore, one must identify the essential attributes of exchange-traded futures contracts that necessitated their regulation.

The Concept Release and the CFTC's other recent pronouncements on swaps appear to be based on the premise that, because certain swaps have payment features that are "economically similar" to and serve the same risk-shifting purpose as futures contracts, they are within the class of transactions that Congress intended to regulate under the CEA as futures contracts. This "economic equivalence" test implies that any transaction that allocates between the transacting parties the bilateral price risk associated with future changes in the price of a commodity, without conveying the ownership of that commodity, is a futures contract.

In the Committee's view, economic equivalence is a necessary but ***not*** sufficient condition to determine whether or how Congress intended to regulate a particular class of transactions. **4** It is not clear that the CEA requires, or even permits, application of the economic equivalence analysis underlying the Concept Release. The CEA grants the CFTC jurisdiction over futures contracts and commodity options. In order to have jurisdiction over an instrument, the CFTC has to determine that the instrument ***is*** a futures contract or a commodity option, not simply that it resembles a futures contract or commodity option because certain component payment features are economically similar to the payment features of a futures contract or commodity option.

It is evident from the history of so-called "leverage transactions" that Congress itself has explicitly rejected the doctrine of economic equivalence and has done so specifically in the context of the CEA.**5** Very generally, leverage transactions can be characterized as long-term precious metals margin accounts. Under these arrangements, a customer typically placed a good faith deposit of 25-30% with the leverage merchant and would be obligated to purchase the underlying precious metal at maturity or, at its option, could resell the leverage contract to the leverage merchant. Accordingly, leverage transactions were economically equivalent to futures contracts and would not have qualified for the forward exemption because the customer could avoid the delivery requirement by entering into an offsetting contract with the leverage merchant at or prior to maturity. From 1974 through 1986, there were extensive debates in Congress regarding the status and regulatory treatment under the CEA of leverage transactions.

Although the history of these deliberations is somewhat convoluted, their final results may be summarized as follows:

- despite their economic equivalence to futures contracts, leverage transactions were ***not*** subject to regulation as futures contracts under the CEA;
- the CFTC was permitted to regulate ***only standardized*** leverage transactions; and
- non-standardized leverage transactions were not subject to regulation as futures contracts or otherwise under the CEA.

These events demonstrate that Congress has expressly repudiated economic equivalence as a basis for regulatory characterization under the CEA.

This result is entirely consistent with other areas of financial market regulation. For example, debt securities, commercial loans, certificates of deposit and guaranteed investment contracts are economically equivalent forms of indebtedness. Similarly, letters of credit, bank guarantees, financial guarantee insurance, affiliate guarantees and put options are economically equivalent forms of credit support. The fact that no two forms of indebtedness or credit support instruments are subject to the same regulatory treatment (and not all are even subject to regulation) results, at least in part, from the different public policy issues raised by the non-economic attributes of the instruments. **6**

The treatment of such instruments demonstrates that Congress generally has not endorsed economic equivalence as the sole basis for determining the regulatory status of financial instruments.

B. The CFTC Should Not Establish an Affirmative Comprehensive Regulatory Regime under the Guise of an Exemption .

As the Commission knows, the CFTC's statutory exemptive authority evolved at the center of an intense debate among regulators, within Congress and within the financial sector over the status and appropriate regulatory treatment of swap transactions. This debate concluded with a bipartisan consensus in favor of a Congressional mandate that both directed the CFTC to take action to promote legal certainty and affirmatively avoided any determination as to the status of swap transactions under the CEA, precisely because Congress and financial regulators (although the issue was squarely framed for resolution by the Congress) did not agree that swap transactions ought to be subject to regulation as futures contracts under the CEA.

Moreover, Congress recognized the significant adverse market consequences that could ensue from an administrative determination that swaps were futures. Mindful of the need to avoid any such consequences, Congress specifically authorized the Commission to exercise its new exemptive authority without making any determination that instruments subject to the new exemptive authority were futures contracts.**7** This approach was consistent with Congress's intent that the Commission exercise its new exemptive authority, in the context of swaps, to promote legal certainty, ***not*** to promulgate a comprehensive regulatory regime for such instruments.**8**

It requires a feat of Orwellian dimension by the Commission to characterize that grant of exemptive authority intended to promote legal certainty as the foundation on which to construct an affirmative comprehensive regulatory regime for OTC derivatives. The Commission should only use its statutory authority as the foundation for an alternative regulatory scheme in cases where the Commission's jurisdiction over the affected activity is clear. Given the legislative record relating to swaps and hybrids, there is no basis on which the Commission can reasonably conclude that Congress has granted jurisdiction to the Commission in the context of such instruments.

C. Congress Intended to Examine this Issue Itself.

The legislative history of the Futures Trading Practices Act of 1992 (the "FTPA ") makes it clear that Congress contemplated that ***Congress***, with input from several federal financial regulators, would be the engine for further deliberation over the regulatory status of OTC derivatives. The Conference Report provides, in pertinent part, that:

> [T]he Conferees have found that it would be useful in the development of ***legislation*** relating to markets for derivative financial products to acquire more extensive and specific information in their regard than is currently available. Therefore, the Conferees direct that the Commissionwith the cooperation of and in consultation with the Securities and Exchange Commission and the Board of Governors of the Federal Reserve Systemconduct a comprehensive study [of the markets for swaps and other OTC derivatives]. . . . The Conferees direct that . . . the Commission shall ***submit to Congress*** . . . any recommendations of the Commission regarding the regulation of the trading of [financial derivative] products and contracts.**9**

More recently, the Chairmen of the House and Senate Agriculture Committees and the Agriculture Appropriations Subcommittees collectively reiterated this intention:

> The appropriate regulation of swaps and other OTC derivatives raises profound questions of public policy that should be addressed in Congress. Legislation to reauthorize the CFTC and reform the [CEA] is the appropriate venue for debating these questions.**10**

D. <u>Only Congress Can Provide the Necessary Degree of Legal Certainty.</u>

Despite significant efforts by Congress and by the CFTC under previous administrations to provide legal certainty for privately negotiated swaps and hybrid instruments, questions nonetheless remain as to certain categories of swaps and hybrids, particularly those that involve non-exempt securities.

Because the Swap Exemption, the Swap Policy Statement,**11** the Hybrid Exemption**12** and the Statutory Interpretation Concerning Hybrid Instruments**13** are administrative pronouncements, they are perceived as being vulnerable to explicit or implicit revocation or modification by the CFTC without additional guidance from Congress and without regard to the existing consensus among financial market participants regarding the intended scope of these precedents. Recent actions of the CFTC, including publication of the Concept Release, have reinforced the perception that the Commission may be inclined to take such unilateral action.

The legal uncertainty problem is particularly acute, however, in the context of swaps and hybrid instruments involving non-exempt securities, as a result of statutory limitations on the Commission's exemptive authority with respect to Section 2(a)(1)(B).**14** For the Commission to take action that would, in effect, ***increase*** the legal uncertainty of such transactions would be squarely at odds with the intent of Congress. Congress specifically stated in 1992 that it "did not intend to call into question the legality of securities-based swap or other [privately negotiated] transactions, which occur in the private marketplace at the present time."**15** Congress is the only institution capable of determining that swaps and hybrid instruments involving non-exempt securities should be regulated under the CEA without placing the entire class of transactions at risk as a result of any such determination.

III. INDIVIDUALLY NEGOTIATED SWAPS AND HYBRIDS ARE NOT APPROPRIATELY REGULATED AS FUTURES CONTRACTS UNDER THE CEA*.*

A. Swaps Raise Different Policy Issues than those Addressed by the CEA*.*

An analysis of the text and legislative history of the CEA reveals that Congress was concerned not only with the economic attributes of futures contracts, but also with the public policy issues related to the non-economic aspects of futures contracts and the manner in which they were traded. Specifically, the CEA recites the following legislative findings:

> [F]utures transactions are carried on in large volume by the public generally and by persons engaged in the business of buying and selling commodities and the products and byproducts thereof in interstate commerce. The prices involved in such transactions are generally quoted and disseminated . . . as a basis for determining the prices to the producer and the consumer of commodities and the products and byproducts thereof . . . . The transactions and prices of commodities on such boards of trade are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed, to the detriment of the producer or the consumer . . . rendering regulation imperative for the protection of such commerce and the national public interest therein.[16]

These concerns are uniquely associated with exchange-trading of futures contracts. For example, the standardization of deliverable grades of commodities, delivery locations and delivery times characteristic of futures contracts, as well as the "long" party's right to demand delivery of the underlying commodity, create distinct markets that are smaller and more concentrated than the broader national market for the underlying commodity. These "micro" markets are more susceptible to potential congestion and corresponding price distortions. Moreover, because the futures markets perform an essential price discovery function in the cash markets for commodities, price distortions in the futures markets can spill over into the cash markets and disrupt the broader economy. In response, Congress enacted a regulatory scheme whose primary goal was to ensure the integrity of commodity markets and to prevent price distortions and market manipulation.

Swap contracts plainly do not present the same risks of market manipulation that Congress sought to address by enacting the CEA. Because swap contracts are individually negotiated between private parties, neither the underlying assets nor the maturity dates of swap contracts are standardized. In addition, most swap contracts are cash-settled; physical delivery of the underlying asset is rarely required. Physical delivery provisions are not, in any event, standardized as to location, time period and deliverable grade.

In addition, the prices negotiated by swap counterparties are not used as a price source by the cash markets for the underlying assets. As a result, the prices that are individually negotiated in connection with swap transactions do not create price distortion in the cash markets. To the contrary, settlement of swap transactions is often based on rates or prices determined by large, liquid cash markets such as the foreign exchange and sovereign debt markets, which are difficult to manipulate even by the largest central banks working in concert.

In the legislative history of the FTPA, the Conference Committee explained that:

> [Swaps] may contain some features similar to those of regulated exchange-traded products but are sufficiently different in their purpose, function, design, or other characteristics that, as a matter of policy, traditional futures regulation . . . may be unnecessary to protect the public interest and may create an inappropriate burden on commerce. [17]

Indeed the Concept Release itself states that:

> [T]he Commission has recognized that differences between exchange-traded markets and the OTC derivatives market warrant differences in regulatory treatment.[18]

Customer protection is clearly another important public policy concern under the CEA. However, privately negotiated swaps do not raise the same fraud and related customer protection issues as those the CEA was designed to address. This is because the CEA was designed to address the types of abuses that arise in markets where transactions are executed by agents who have exclusive access to the market and who deal with retail investors. However, in the context of bilateral transactions between sophisticated counterparties, each party must specifically agree to each term of the contractual relationship, including price. In this context, the need for regulatory protections against fraud and customer abuse is vastly diminished. As the Commission acknowledges in the Concept Release:

> [T]he decentralization of trading in the OTC market and the relative sophistication of the participants have meant that issues of financial integrity and customer protection differ from exchange markets. [19]

Accordingly, individually negotiated swaps do not raise the public policy concerns the CEA was enacted to address. Even the most superficial analysis of the CEA demonstrates that its structure and design are fundamentally inconsistent with the regulation of individually negotiated swaps. For example, the entire focus of the CEA is on the qualification of exchanges on which futures transactions are required to be conducted and the regulation of futures commission merchants who are required to act as agents for public customers. The hallmarks of swaps are (i) that they are ***not*** conducted on exchanges and (ii) that they are individually negotiated principal-to-principal transactions.

B. Hybrid Instruments also Raise Different Policy Issues than those Addressed by the CEA.

For several reasons, hybrid instruments present to an even lesser extent than swaps the policy concerns raised by exchange-traded futures that Congress sought to address through the CEA. First, as the CFTC acknowledged in the adopting release for the Hybrid Exemption, hybrid instruments "do not represent a relevant pricing mechanism for the general price discovery process of the underlying commodity."[20] Second, under the criteria set forth in the Hybrid Exemption, the capital-raising function of a hybrid instrument must predominate over the commodity risk-shifting function. The effect of this requirement is to dilute the potential impact of each dollar invested in a hybrid instrument on the cash market for the underlying commodity. Third, the Hybrid Exemption precludes the settlement of hybrid instruments by means of a delivery instrument, such as an exchange-approved warehouse receipt or shipping certificate, that can be used to settle exchange-traded futures or options contracts.[21] The express purpose of this provision was "to reduce the likelihood of pricing anomalies on designated contract markets."[22]

The principal regulatory challenge presented by hybrid instruments is not to prevent commodity price manipulation but, as is the case with more traditional securities, to ensure the adequacy of disclosure regarding the economic performance of and risks associated with the investment. However, the CEA was designed to protect markets against price manipulation and fraud, not to facilitate disclosure of material information to the capital markets. By contrast, disclosure is at the heart of the federal securities laws. Accordingly, hybrid instruments are more appropriately regulated under the securities and banking laws than under the CEA.

There is a suggestion in the Concept Release that the scope of commodity price dependency permitted under the Hybrid Exemption may be too broad. The Committee disagrees strongly with this suggestion. First, the fact that investors may lose principal as a result of commodity price changes does ***not*** distinguish this risk factor from the myriad other risk factors that might cause investors in securities to lose the principal amount they have invested. Second, as a practical matter, the exemption has operated relatively effectively and without generating market problems of any kind. Although application of the so-called "predominance test" might not be self-evident to or well understood by nonprofessionals, among the investment banks and commercial banks who create these products, the test is understandable and works.

Finally, Congress understood the scope of the exemptive authority it was permitting the CFTC to exercise in the context of hybrid instruments that are "predominantly" securities. An earlier provision considered by Congress would have excluded from the CEA, *inter alia,* hybrid instruments that were predominantly securities. In correspondence to Congress recommending Congress's adoption of the provision, the Commission explained and attached examples illustrating how it would apply the "predominance" criterion. Part 34 of the Commission's regulations effectively codified the described approach.[23]

IV. MARKET DEVELOPMENTS DO NOT JUSTIFY FURTHER REGULATORY INITIATIVES TARGETED AT SWAPS OR HYBRID INSTRUMENTS

The Committee does not believe that the market developments described in the Concept Release warrant any regulatory initiatives specifically directed to OTC derivatives, much less the comprehensive regime heralded by the Concept Release. The CFTC premises the need for a possible expansion of its supervision of OTC derivatives dealers on market growth, reported financial losses and allegations of abusive sales practices by dealers. The conclusion that further regulation is justified by these developments is supported neither by logic nor by the empirical data cited by the CFTC. While many of the "losses"[24] cited by the CFTC do not involve OTC derivatives, many of these losses do involve regulated products used by sophisticated and regulated entities. The data cited by the CFTC demonstrate no correlation between the use of OTC derivatives, as opposed to futures, securities or other financial instruments, and large financial losses, nor do the data demonstrate any correlation between the lack of regulation and large financial losses.

On the other hand, there is a significant correlation between large financial losses and the assumption of large positions, in cash-market and exchange-traded and OTC derivatives instruments, based on market predictions that later prove inaccurate. Most frequently they occur in the context of significant market breaks or changes in prevailing financial asset-class regimes. In other words, these losses occur not because of the particular type of financial instrument involved, but because of the decision to assume a particular market exposure. Large exposures to, for example, changes in interest or exchange rates, can be created using exchange-traded futures or cash-market securities as well as OTC derivatives.

Frequently, the prudence of these positions is questionable. Sometimes, the examples of losses raise questions as to whether internal controls were adequate to ensure that the decision to assume the relevant risk was made at the appropriate level of the contracting organization. Sometimes, misjudgments are made regarding the liquidity requirements that are necessary to maintain a position in sustained adverse market environments. Each of these involves questionable business judgments (at least, questionable with the benefit of hindsight). For the most part, the community of participants in the financial markets professional and nonprofessional has learned and is learning from large loss experiences and is responding with the adoption of measures designed to address perceived weaknesses in prior practice. The losses that have occurred do not evidence pervasive fraud or other misconduct by market participants. They do not signal a need for regulatory intervention in the context of OTC derivatives specifically.

A. <u>Robust Market Growth Does Not Justify Further Regulation</u>.

The Concept Release implies that the "explosive" growth in the volume of privately negotiated derivatives contracts justifies regulatory intervention. However, the CFTC does not explain how the increased use of OTC derivatives has altered the public policy judgment that motivated the enactment of the FTPA and the promulgation of the CFTC's various exemptions.

Congress has not viewed the growth of the OTC derivatives market as a rationale for establishing a comprehensive scheme of regulation by the CFTC. When considering the FTPA, Congress noted that the volume of trading in OTC derivatives had "ballooned" over the past decade.[25] Indeed, even at that time, the scope of the relevant activity was estimated at approximately $4 trillion in aggregate notional amount. Rather than seeking to restrain this growth, Congress encouraged the CFTC to exercise its exemptive authority precisely to promote "financial innovation and market development" *i.e.,* further growth.[26]

The growth in the use of OTC derivatives is, far from evidence of a problem in need of regulatory intervention, evidence of the salutary impact of these activities. The extent to which American businesses have embraced these transactions as risk management tools reflects the confidence end-users have in the integrity of their counterparties and the activity as a whole. Thus, in the Committee's view, the substantial growth in the scope of activity in swaps, particularly against the background of the relatively few problems that have arisen and are specifically attributable to swaps, undermines the Commission's contention that there is a pressing need for regulation by the Commission.

B. <u>Losses Alluded to in the Concept Release Do Not Justify Further Regulation</u>.

1. Losses Alone Do Not Indicate the Need for Regulation.

The fact that sophisticated parties to financial transactions experience losses, even large and widely publicized ones, does not necessarily indicate that the market is not functioning properly or that market participants are behaving in an undesirable fashion. The OTC derivatives market is based on the voluntary transfer of risk from one party to another. Parties to these transactions anticipate the possibility of losses. As the End-Users of Derivatives Association, Inc. ("<u>EUDA</u>") has indicated:

> [E]nd-users by and large accept the risk of financial losses associated with derivative commitments and have in fact experienced such losses without dispute. . . . It is neither possible nor desirable to prevent end-users from realizing financial losses from derivatives transactions . . . .[27]

Relying on data presented in the GAO Report, the Commission implies that there is a causal relation between losses and abusive sales practices by OTC derivatives dealers. EUDA, among others, has challenged the link between losses and sales practice disputes. According to EUDA, the GAO Report may be misleading to the extent that it

> does not reflect the fact that . . . end-users have suffered large derivatives losses without raising any objection to dealer conduct. . . . [Such] losses in large part were not unexpected in the sense that the derivatives operated as anticipated and were offset by gains in the underlying hedged items.[28]

Put plainly, OTC derivatives are intended to produce, in equal measure, losses and gains. That is their function. It is not the role of the CFTC to prevent sophisticated market participants from assuming imprudent risks.

2. The Specific Losses Cited by the Commission Do Not Indicate the Need for Regulation.

The sources cited in the Concept Release similarly do not establish the lack of regulation as a cause of losses by users of OTC derivatives. Both the Markham treatise on commodities law [29] and the GAO Report cited by the Commission refer to many transactions that either do not involve OTC derivatives at all or involve problems unrelated to any specific type of transaction.[30] Markham, for example, describes sensational losses by, among others, Kidder, Peabody, Orange County, Barings PLC, City Colleges of Chicago, Bank of Montreal, Cargill, Daiwa Bank Ltd. and Sumitomo.

Kidder, Peabody's losses arose from a bond trader's booking profits on transactions that never existed. Orange County's losses resulted from reverse repurchase agreements involving structured notes regulated as securities. Barings PLC was bankrupted by unauthorized trades on a regulated futures exchange. City Colleges of Chicago, Bank of Montreal and Cargill suffered losses related to mortgage-backed securities. Daiwa's losses involved U.S. Treasury bonds. Sumitomo's losses arose from unauthorized trading in physical copper and in copper futures and options on regulated exchanges. Markham also refers to an English case in which the court held that English municipalities lacked authority to enter into OTC derivatives. Thus, a substantial number of the examples of losses cited are just irrelevant to the issues raised in the Concept Release. Many of the other losses described by Markham resulted from the 1994 debt market break, which caused large losses in all interest-rate sensitive investments. Many of these losses involved regulated investments and transactions conducted by regulated entities.

The GAO Report, which the Concept Release also cites as evidence of substantial end-user losses and widespread sales practice concerns, conflates survey results related to OTC derivatives with data on mortgage-backed securities and structured notes. The Concept Release states that the GAO Report identified 360 substantial end-user losses,[31] but neglects to mention that these losses include losses on mortgage-backed securities, structured notes and other products that are not OTC derivatives. [32] The Concept Release quotes the GAO Report as indicating that "sales practice concerns were raised in 209, or 58 percent, of the [360 end-user] losses," [33] but omits the following sentence, which explained that only 18 of these examples involved OTC derivatives and that a single dealer, which was a regulated entity, was involved in 9 of the 18 sales disputes.[34] Accordingly, fully 95 percent of the examples of losses cited in the Concept Release are irrelevant to the Commission's discussion of sales practice concerns.

Moreover, although large losses have inspired sensational headlines in the business press, the absolute size of any particular derivatives loss has little meaning. The significance of derivatives losses must be considered in the context of the assets of the affected parties and the enormous scope of the activity undertaken in the market as a whole. Viewed in that context, the losses incurred specifically as a result of OTC derivatives alone are simply not that impressive. In any event, as noted above, it is the purpose of OTC derivatives to create corresponding losses and gains as market factors change in value or level.

3. Losses to Date Have Demonstrated No Systemic Effects.

Despite the large losses attributed by the Commission to derivatives transactions, no systemic effects from these losses have been observed. Notably, even the most spectacular losses from "derivatives" transactions (broadly defined), such as those sustained by Barings PLC and Orange County, did not spill over into other institutions or markets. Inter-dealer credit exposures from OTC derivatives have plateaued, as dealers have reached their internal credit limits for unsecured exposures to one another and established collateral arrangements to secure any additional derivatives exposure.

The recent events involving Long-Term Capital Management ("LTCM") similarly do not represent a sea change in the market conditions that inspired Congress to encourage the Commission to exempt privately negotiated swaps and hybrids from regulation under the CEA. Although the LTCM situation raises a number of legitimate public policy issues, the need for specific regulation of OTC derivatives is not among them. While LTCM used OTC derivatives, most of LTCM's leverage was obtained through the use of debt financing, not OTC derivatives. Indeed, under current margin rules, LTCM could have achieved two to three times *greater* leverage in the exchange-traded futures markets, which are already supervised by the Commission. Moreover, most of LTCM's losses stemmed from its cash-market positions in securities, not from positions in OTC derivatives.

To the extent that LTCM's trading activities, or the activities of its creditors, warrant further scrutiny,[35] the Committee does not believe that OTC derivatives should be a central focus of that scrutiny. In any event, given the issues involved, the Committee believes that Congress is the appropriate entity to consider the relevant issues. Precipitous unilateral action by the Commission would be wholly inappropriate under these circumstances.

C. Sales Practices.

1.End-Users of Derivatives Are Generally Satisfied with Sales Practices.

Although the Commission identifies sales practice concerns as warranting further regulation of the OTC derivatives market, the Commission has offered no evidence suggesting that sales practice disputes among parties to privately negotiated derivatives contracts are either more frequent or more egregious than in other areas of commercial dealings. Quite the opposite is suggested by the very GAO Report cited by the Commission in the Concept Release. According to the GAO Report, "most end-users were generally satisfied with the sales practices of the dealers with whom they entered transactions." In addition, the report recites that:

> [S]ales practice concerns are not widespread relative to the limited number of dealers involved in the losses that have been reported, the thousands of transactions that have occurred over the period discussed, and the hundreds of billions of dollars at risk in these transactions.[36]

In fact, only two percent of the organizations that had used OTC derivatives products reported being somewhat or very dissatisfied with the sales practices of the dealers with whom they did business. End-users reported a higher level of dissatisfaction with dealers with whom they did not transact. Notwithstanding the Commission's assertion that even large and sophisticated market participants lack "meaningful protection against sales practice concerns,"[37] the GAO data suggest that end-users are not only capable of evaluating the sales practices of dealers but that they are also capable of protecting themselves from abuse by dealing selectively with dealers with whom they are comfortable.

2.Sales Practices by Many Dealers Are Already Regulated.

As the Commission is aware, the vast majority of OTC derivatives dealers are currently subject to some form of sales practice regulation. Many OTC derivatives dealers are banks, which are subject to regulation by the Federal Reserve Board and the Office of the Comptroller of the Currency, or broker-dealers, subject to oversight by the SEC. Although approximately 10% of the activity is accounted for by unregulated affiliates of securities firms, the GAO has itself estimated that 90 percent of this activity is conducted by firms adhering to the Derivatives Policy Group's "Framework for Voluntary Oversight" (the "DPG Framework"), a framework which was developed in cooperation with the Commission.[38]

Moreover, regulation of sales practices will not necessarily result in higher levels of end-user satisfaction. The GAO Report found lower levels of end-user satisfaction with the sales practices of dealers of mortgage backed securities (7 percent) and structured notes (13 percent), the sales of which are subject to oversight by both the SEC and the NASD.

3.Relationship between Dealers and End-Users Is Individually Negotiated.

The Commission cites the possibility that dealers and end-users may have different views as to the nature of their relationship as a basis for imposing sales practice rules on OTC derivatives dealers. However, the GAO Report data relied on by the Commission may no longer reflect the current state of affairs. The GAO data results from a survey conducted in March 1995, which predates implementation of several important initiatives taken by the industry to clarify the relationship between dealers and end-users.

First, in March 1995, the DPG Framework created an affirmative responsibility for a professional counterparty to clarify the nature of the relationship when it becomes aware that the nonprofessional counterparty mistakenly believes that the professional counterparty has assumed advisory obligations. Second, in August 1995, six financial sector trade groups, in conjunction with the Federal Reserve Bank of New York, released the Principles and Practices for Wholesale Financial Market Transactions (the "Principles"), which defines the relationship among institutional market participants and establishes a code of conduct for dealings among such parties. Third, in March 1996, the International Swaps and Derivatives Association, Inc. ("ISDA") published its standard "Representation Regarding Relationship Between Parties" clause. The inclusion of this clause in standard documentation for OTC derivatives has provided a basis for negotiation between the parties regarding the precise parameters of their relationship.

The result of these developments has been to allow the parties themselves to determine the nature of their relationship. Such a result is clearly appropriate in the context of highly sophisticated parties who satisfy the "eligible swap participant" criteria. Such a result is also clearly preferable to a federally mandated definition that would apply to parties of widely varying circumstances and transactions of widely varying levels of complexity. As the GAO Report concluded:

> [T]he type of relationship and accompanying responsibilities that should prevail in OTC derivatives transactions should be agreed upon by market participants[;] . . . the issues surrounding their relationships are complex and federal involvement may not necessarily result in an agreement that is widely accepted.[39]

4.Intervention Would Result in Increased Costs without Offsetting Benefits.

Imposing fiduciary-like accountability on OTC derivatives dealers for the prudence of a counterparty's transactions would, *inter alia*, create a moral hazard analogous to the one that resulted in the S & L debacle. By encouraging counterparties to believe that they are not ultimately responsible for their investment decisions and by placing the burden of imprudent investment strategies on derivatives dealers, such a regime would destabilize markets and contribute to systemic risk.

In addition, imposing obligations of a fiduciary character would require dealers to undertake a review of data and an analysis that they do not currently undertake, except where they specifically contract to do so. This would generally increase the cost (and risk) of a transaction for a dealer. Many counterparties are not willing to provide dealers with the information that would be required to evaluate the prudence of a transaction, and would not welcome the attendant increase in costs. It is far more efficient and preferable, including for end-users, to permit the parties to define contractually the scope of their obligations and expectations.[40]

D. Swaps Have Not Become Standardized.

The Concept Release suggests that swap activity in the United States has become standardized.[41] The Committee disagrees. The Committee is not aware of any standardization of swap transactions in the United States. In this regard, the Committee believes that the Commission may be confusing the convention of quoting indicative rate levels for stated transaction maturities with standardization of resulting transactions. Market participants use indicative pricing to identify potential counterparties. The exchange and use of indicative pricing does not bind either potential counterparty to a transaction of specific terms, or even to the indicative rate quoted. Indicative pricing is used only for the purpose of identifying counterparties with whom a meeting of the minds is likely to exist as to prevailing rates or prices. Thereafter, all material terms of a transaction, including maturity and specific rates used, are subject to individual negotiation.

As the Commission also acknowledged in the preamble to the Swap Exemption:

> [S]tandardization of terms in published forms is not dissimilar to the standardization of terms for other areas, such as letters of credit. The standardization of such terms facilitates communications and negotiations, but does not mean the provisions themselves are not subject to substantial negotiation.[42]

Similarly, any market trend toward greater concentration of activity in certain common maturities also does not mean that the underlying transactions are standardized. Any such tendency does not necessarily lead to fungibility and thus such concentration also does not mean that these transactions are no longer subject to individual negotiation or have become functional equivalents of fungible, offsettable exchange-traded futures contracts.

E. Restricting Swap Activity or Imposing Artificial Constraints to Promote "Fair Competition" and "Even-Handed Regulation" between the OTC Market and Exchanges Is an Inappropriate Goal.

The Committee believes that the Commission's policy objective should be to address the legitimate regulatory issues raised by each category of activity or market, based on their merits, not to allocate the market for risk management products among competing providers. Section 4(c)(2)(B)(ii) of the CEA requires the Commission in exercising its exemptive authority to consider the potential impact on the ability of contract markets to discharge their self-regulatory duties. However, Congress "[did] not intend for this provision to allow an exchange or any other existing market to oppose the exemption of a new product solely on grounds that it may compete with or draw market share away from that existing market."[43]

V. POSITIVE IMPACT OF OTC DERIVATIVES MARKET

Notwithstanding the skeptical view of the rapid growth of the OTC derivatives market underlying the Concept Release, the Committee believes that the increasing availability of these products has had a very favorable impact on companies in all sectors of the U.S. economy. Facilitated by advances in modern finance theory and computer technology, the growth in OTC derivatives has had an important salutary influence on the financial services industry generally as well as on corporate America reaching well beyond the financial sector firms that intermediate derivatives transactions.

The growth in OTC derivatives activity has made risk management tools available to end-users in every sector of the U.S. economy, allowing end-users to manage with enhanced efficiency their exposure to prices and rates in the often volatile foreign exchange, money, equity, commodity and credit markets. Exposure to OTC derivatives and related technologies has introduced companies to risk management as a fundamental corporate discipline. Risk management, as a discipline, is not limited to price risk management, but potentially encompasses all aspects of the operational risks to which an enterprise is subject. This discipline compels companies to evaluate the risks to which they are subject much more self-consciously and systematically than they have in the past. This is a development from which we all benefit.

The Committee is concerned that precipitous regulatory action by the Commission where it is not needed will have a chilling effect on this beneficial process of innovation. Although the process is not free from risk for market participants, the Committee believes that any short-term benefit that might conceivably be gained by the sweeping regulatory regime envisioned in the Concept Release will come at the cost of suppressing the process of innovation. Moreover, the Committee believes that the long-term benefits of allowing innovation in risk management to continue will vastly outweigh any perceived benefits resulting from short-term regulatory intervention.

VI. CONCLUSION

The Committee urges the Commission to defer to Congress on the issues raised in the Concept Release and to resist the temptation to try to address episodic, imprudent market practices through regulatory intervention that will provide only illusory benefits at the risk of interfering with the efficient development and trading of an important class of risk management tools.

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If you have any questions or would like further information regarding this letter, please feel free to contact Gerard J. Quinn, Staff Adviser to the Committee, at 212-618-0507, or Edward J. Rosen of Cleary, Gottlieb, Steen & Hamilton, counsel to the Committee, at 212-225-2820.

Very truly yours,

Zachary Snow, Chairman
OTC Derivative Products Committee

cc: Chairperson Brooksley Born
Commissioner Barbara Pedersen Holum
Commissioner James E. Newsome
Commissioner David D. Spears
Commissioner John E. Tull, Jr.

Footnotes:

1 SIA brings together the shared interests of nearly 800 securities firms, employing more than 380,000 individuals, to accomplish common goals. SIA members including investment banks, broker-dealers, and mutual fund companies are active in all markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans, and accounts for $270 billion of revenues in the U.S. economy.

2 63 Fed. Reg. 26114 (May 12, 1998).

3 CEA, § 3 (emphasis added).

4 Among other attributes, the economic equivalence approach ignores considerations such as standardization, fungibility and other characteristics of exchange-traded futures that have influenced their regulatory treatment. See Section III below for discussion of the elements of exchange-traded futures that raise public policy issues addressed by the CEA.

5 See, generally, CEA § 19, 17 C.F.R. Part 31 and Proposed Regulation of

Leverage Transactions as Contracts for Future Delivery or Otherwise, 44 Fed. Reg. 13494 (Mar. 12, 1979).

6 Insurance contracts are another example of contracts that demonstrates that economic equivalence alone is not determinative of an instrument's regulatory status. Insurance contracts can be economically similar to commodity options (consider, for example, crop yield protection). They can transfer economic risk (including price risk) from one party to another (without necessarily conveying any ownership interest) and are often standardized. Appropriately, however, insurance contracts are not regulated as option contracts under the CEA.

7 As stated in the Conference Report:

> [T]his provision provides flexibility for the Commission to provide legal certainty to novel instruments where the determination as to jurisdiction is not straightforward. Rather than making a finding as to whether a product is or is not a futures contract, the Commission in appropriate cases may proceed directly to issuing an exemption.
>
> H.R. Conf. Rep. No. 102-978, 102d Cong., 2d Sess., 83 (Oct. 2, 1992) (hereinafter, "Conference Report").

8 Conference Report at 83.

9 *Id.* at 83-84 (emphasis added).

10 Sens. Richard Lugar and Thad Cochran and Reps. Robert Smith and Thomas Ewing, Joint Statement Regarding the Regulation of Over-the-Counter Derivatives (Aug. 6, 1998).

11 Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30694 (July 21, 1989).

12 Hybrid Exemption at 5582.

13 Statutory Interpretation Concerning Certain Hybrid Instruments, 54 Fed. Reg. 13582 (Apr. 11, 1990).

14 Under CEA § 2(a)(1)(B)(v), non-exempt securities are securities that are not exempt under Section 3 of the Securities Act of 1933 or Section 3(a)(12) of the Securities Exchange Act of 1934, as in effect on the date of enactment of the Futures Trading Act of 1982, other than any municipal security as defined in Section 3(a)(29) of the Securities Exchange Act of 1934, as in effect on the date of enactment of the Futures Trading Act of 1982.

15 Conference Report at 78. Congress was aware at the time, as a result of testimony given during its consideration of the FTPA, that transactions in swaps (including swaps involving non-exempt securities) were being conducted in reliance on the Swap Policy Statement.

[16] CEA § 3.

[17] Conference Report at 80.

[18] Concept Release at 26119.

[19] Concept Release at 26119.

[20] Hybrid Exemption at 5582.

[21] 17 C.F.R. § 34.3(a)(3)(iii)

[22] 58 Fed. Reg. 5580, n. 11.

[23] Letter from Wendy L. Gramm, then-Chairman of the Commission, to the Honorable Patrick Leahy, then-Chairman of the Committee on Agriculture, U.S. Senate (Apr. 9, 1991) (transmitting technical amendments to Title III of the Futures Trading Practices Act of 1991 (S. 207, 102d Cong.)).

[24] Many "losses" represented positions that offset hedged cash-market positions in which there were countervailing gains.

[25] Conference Report at 81.

[26] *Id*.

[27] Letter from EUDA to the U.S. General Accounting Office ("GAO") (Aug. 1, 1997) (commenting on a draft of the GAO report, OTC Derivatives: Additional Oversight Could Reduce Costly Sales Practice Disputes, GAO/GGD-98-5 (Oct. 1997) (the "GAO Report")) (reprinted in the GAO Report at 202) (the "EUDA Letter").

[28] EUDA Letter.

[29] Jerry A. Markham, Commodities Regulation, Fraud, Manipulation & Other Claims, Section 27.05 nn. 2-22.1 (1997) (cited in the Concept Release at n. 6).

[30] The Concept Release acknowledges, in a footnote, that "some of these transactions involved instruments that are not subject to the CEA." Concept Release at n. 6.

[31] Concept Release at 26115.

[32] See GAO Report at 10.

[33] Concept Release at 26125.

[34] GAO Report at 10.

[35] In this regard, the Committee notes that LTCM is a commodity pool

operator regulated by the CFTC under its current statutory authority. As such, there are no restrictions on the information that the CFTC may require from LTCM regarding pool investments.

36 GAO Report at 223-24.

37 Concept Release at 26125.

38 GAO Report at 13.

39 GAO Report at 18, 136.

40 The Committee finds it noteworthy that the comparable customer protection provisions of the Commission's regulations, even in the case of retail investors, consists of a standard form risk disclosure statement.

41 The Committee notes that the Commission has also requested comment on the appropriate regulatory approach to market innovations such as electronic trading and clearing facilities. Although the Committee has significant questions with respect to the Commission's jurisdiction over such issues (clearing, in particular), the Committee believes, in any event, that the Commission should not attempt to address fundamental questions about new market paradigms, such as electronic trading, in the context of an abstract rulemaking. Rather, the Committee urges the Commission to address these issues, on an *ad hoc* basis, in response to specific requests for relief, where the Commission will have the benefit of specific facts within which to frame its analysis of the related policy implications of the activity.

42 Exemption for Certain Swap Agreements, 58 Fed. Reg. 5587, 5590, n. 27 (Jan. 22, 1993).

43 Conference Report at 79.