

**TESTIMONY OF  
MARC LACKRITZ, PRESIDENT  
SECURITIES INDUSTRY ASSOCIATION**

**REGARDING THE  
REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS**

**ENTITLED**

**OVER-THE-COUNTER DERIVATIVES MARKETS  
AND THE COMMODITY EXCHANGE ACT**

**BEFORE THE HOUSE AGRICULTURE COMMITTEE  
SUBCOMMITTEE ON RISK MANAGEMENT, RESEARCH AND SPECIALTY CROPS  
UNITED STATES HOUSE OF REPRESENTATIVES**

**FEBRUARY 15, 2000**

I am Marc Lackritz, President of the Securities Industry Association. I appreciate the opportunity to offer you SIA's views on a subject critically important to our membership: over-the-counter ("OTC") derivatives, specifically the recommendations contained in the November 1999 Report of the President's Working Group on Financial Markets (the "President's Working Group") entitled *Over-the Counter Derivatives Markets and the Commodity Exchange Act* (the "Report").

When I last testified before this Subcommittee in June 1998, the Subcommittee was considering the appropriate response to the publication of then-CFTC Chairwoman Born's concept release on OTC derivatives (the "Concept Release"). Published over the objection of the other members of the President's Working Group, the Concept Release called into question the legal status of OTC derivatives, and threatened to destabilize financial markets and undermine a decade of Congressional efforts to promote financial innovation and enhance the competitiveness of the U.S. financial sector. As SIA and others recommended, Congress averted a potential disaster by enacting emergency legislation imposing a moratorium on further CFTC action.

In sharp contrast to the Concept Release, the President's Working Group Report represents a constructive, responsible and practical set of solutions designed to resolve longstanding uncertainties associated with the Commodity Exchange Act ("CEA") that would ensure that U.S. markets remain at the vanguard of financial innovation for years to come. Importantly, its policy recommendations are supported by *all* the federal financial regulators, and enjoy overwhelming support by market participants. SIA congratulates the President's Working Group for its efforts and enthusiastically endorses its recommendations.

However, the Report will be of little value if Congress fails to act on its recommendations. A failure to do so would impair the competitiveness of the U.S. financial sector and reduce the attractiveness of the U.S. as a financial center. Congress has the power to maintain this country's preeminent leadership position in the global financial markets by moving promptly to enact the

Report's recommendations, and SIA would be pleased to assist that effort in any way within our power.

## **I. SIA ENDORSES THE PRESIDENT'S WORKING GROUP RECOMMENDATIONS TO ENHANCE LEGAL CERTAINTY FOR OTC DERIVATIVES.**

### **A. Qualifying bilateral swap agreements involving financial commodities, including transactions based on non-exempt securities, should be excluded from regulation under the CEA.**

For years, market participants have been troubled by the legal uncertainties that have clouded the status of OTC derivatives. This problem is most acute in the context of swaps involving non-exempt securities, because the CFTC lacks statutory authority to exempt these contracts from prohibitions contained in the CEA. This situation has increased legal risk to parties using these otherwise desirable and legitimate products and encouraged them, where feasible, to execute such transactions outside the U.S.

The President's Working Group recommendation to exclude qualifying bilateral swap agreements involving financial commodities from regulation under the CEA is a practical, common sense solution to the legal certainty issue that is consistent with the broader policy framework for financial market regulation. The exclusion for bilateral swaps is consistent with the Treasury Amendment exclusion of certain financial products from regulation under the CEA, and will enable the OTC derivatives markets to flourish and foster financial innovation in the United States. Transactions by institutional market participants in these products do not generally give rise to the price discovery, manipulation and public customer protection concerns addressed under the CEA.

### **B. SIA agrees that the CFTC's authority to exempt hybrid instruments that reference non-exempt securities should be clarified.**

Hybrid instruments are exempt under current CFTC regulations only if they are predominantly securities or bank products. Because these instruments should be and are regulated by other regulators, their status under the CEA should be clear. However, in the case of hybrid instruments involving non-exempt securities, the CFTC lacks the authority to provide comprehensive exemptive relief. SIA agrees with the President's Working Group that the CFTC's authority to exempt from the CEA hybrid instruments involving all securities should be clarified.

In addition, SIA recommends that Congress codify an exclusion from the CEA similar in scope to the CFTC's current exemption for hybrid instruments (the "Hybrid Exemption"). The Hybrid Exemption has been in effect for seven years and has worked well. We are aware of no evidence of abuse or regulatory problems presented by these instruments. We believe that a Congressional codification of this exemption is the appropriate means for establishing the jurisdictional status of these instruments. We would be pleased to work with the President's Working Group and the Committee in assisting that process.

**C. SIA agrees that the electronic trading of qualifying OTC derivatives should be excluded from the CEA.**

Despite the numerous advantages of electronic trading systems, market participants in the U.S. cannot take full advantage of these technological innovations. An attempt to make use of some of these newer, more efficient systems may transform a perfectly legitimate OTC derivatives transaction into an illegal off-exchange futures contract. This fear has severely inhibited the use of such systems in the U.S., even as their use overseas proliferates.

As the President's Working Group recommends, given their manifest benefits Congress should encourage the use of electronic trading of OTC derivatives and eliminate the impediments to such trading arising from the CEA. As the world's leader in technology, it is surely ironic that U.S. market participants are inhibited by the CEA from making use of innovative trading platforms. Failure to adopt the President's Working Group recommendation on electronic trading will materially disadvantage the U.S. financial community.

**D. The use of clearing should not subject otherwise excluded OTC derivatives to CEA regulation; Clearing should be appropriately regulated.**

Clearing of OTC transactions should be encouraged since it allows mutualization of counterparty credit risk, which in turn reduces systemic risk. However, the CEA currently discourages clearing, because arranging to have a trade cleared may subject an otherwise excluded or exempt transaction to regulation under the CEA. SIA agrees with the President's Working Group that clearing should not alter the legal status of the transaction being cleared.

Further, SIA welcomes clarification of the CFTC's authority to regulate clearing independent of the regulatory status of the product being cleared. SIA believes clearing of OTC products should be regulated by an appropriate domestic or foreign authority.

**E. Treasury Amendment products should be excluded from regulation under the CEA unless conducted on an "organized exchange".**

The President's Working Group report affirms Congress's original intent in enacting the Treasury Amendment in 1974, specifically that the banks, broker-dealers, and well-capitalized institutions that comprise the foreign exchange and government securities markets do not require and would not be benefited by the protections afforded under the CEA.

By replacing the term "board of trade" with "organized exchange", as the President's Working Group recommends, Congress will go a long way toward minimizing legal disputes and preempting future litigation in this area. Treasury Amendment products are now among the deepest, most efficient, most liquid, and most important financial markets in the world, and should not be subject to constraints or legal uncertainty under the CEA.

**II. SIA supports the SEC/CFTC dialogue on Shad-Johnson**

SIA continues to believe that the most important issue for Congress to resolve in this area is the legal uncertainty affecting OTC derivatives and hybrid instruments involving non-exempt securities. Accordingly, we do not believe that resolving that issue should be postponed until all of the issues involving the trading of single stock futures have been decided. SIA does not believe single-stock futures should be prohibited by law. However, before these products could be permitted to trade, an examination of the appropriate regulatory infrastructure for them would have to be undertaken, addressing many important issues, such as the integrity of the underlying securities market and questions of regulatory arbitrage. SIA agrees with the President's Working Group that an interagency dialogue, including the other members of the President's Working Group, is the appropriate process for resolving the complex regulatory issues presented by these products. SIA looks forward to the results of that dialogue and stands ready to provide whatever assistance it can in resolving the issues involved.

### **III. CONGRESS SHOULD ENACT LEGISLATION IN ACCORD WITH THE PRESIDENT'S WORKING GROUP REPORT'S RECOMMENDATIONS THIS YEAR.**

SIA concurs with the President's Working Group Report's conclusion that the need for changes in the CEA to enhance legal certainty for OTC derivatives and remove barriers to innovation posed by the CEA is compelling. The problems engendered by the CEA are real and are exacerbated by the increasing globalization of financial markets. Now that the agencies with the relevant expertise have recommended a prudent course of action, Congress should not delay in enacting those recommendations into law. Markets can migrate overnight, and once gone from our shores and ensconced in a new, more hospitable legal environment, may not return. SIA urges the Subcommittee to take the lead in moving Congress to resolve these long standing issues this year.

### **IV. CONCLUSION**

SIA is greatly encouraged by the President's Working Group Report. The fact that the constituent members of the Working Group, notwithstanding historical differences in views, could reach such a broad consensus on so many important issues is a testament to the seriousness with which they undertook their work. We respectfully request that Congress now move in the same cooperative spirit to enact the Report's recommendations. SIA stands ready to assist the Agriculture Committee in any way we can in moving to the enactment of responsive and responsible legislation this year. Thank you for the opportunity to be heard on this important issue.