April 8, 1991

The Honorable Christopher Dodd
Chairman, Subcommittee on Securities
534 Senate Dirksen Office Building
Washington, DC 20510

Dear Senator Dodd:

SIA is pleased to respond to your letter of March 28, 1991, to express our views on Title III of S. 207, The Futures Trading Practices Act, as reported by the Senate Agriculture Committee. As you are aware, SIA has had a longstanding interest and involvement in many of the issues raised by this title. SIA strongly believes that both the general objectives and specific provisions of Title III as reported out by the Agriculture Committee are deeply flawed.

First, you asked about the uses of, and markets for swaps and hybrid securities. Hybrid products and swaps are innovative new financial products that are vital for clients to manage risk and uncertainty in an increasingly risky and uncertain environment. Effective risk management aids the capital-raising process, thus improving long-term investment as well as economic growth for our nation. Moreover, effective risk management in the financial markets helps to promote safety and soundness of the entire financial system, as well as restore confidence in our markets. Any legislation affecting swaps and/or hybrid products should therefore enhance the capital-raising process by reducing uncertainty, encouraging further innovation and preserving the efficiency and international competitiveness of these products and markets. Unfortunately, we strongly believe that the provisions concerning swaps and hybrids (Sections 302 and 303) of S. 207 as reported will in fact undermine these very objectives that we all believe are so critically important. Before describing the specific problems created by these provisions as reported, we offer a brief chronology of SIA's interest and involvement in the evolution of this legislation.

Following the 1987 market break and the report of the Presidential Task Force on Market Mechanisms ("Task Force") chaired by now Secretary of the Treasury Nicholas F. Brady, SIA endorsed the major recommendations of the Task Force, including calls for one principal regulator to coordinate the critical regulatory issues which affect related market segments throughout the financial system, as well as one unified consistent margin-setting authority for functionally related products such as stocks, stock options and stock index futures. The Task Force and SIA also endorsed coordinated circuit breakers for the equity and equity-related markets.

After the 1989 "mini-crash," SIA again supported these and other proposals and made further recommendations to help curb the unsettling bursts of severe intraday volatility affecting the equity markets. The Administration's "Capital Markets Competitiveness, Stability and Fairness Act" (S. 2814), introduced last Congress, addressed virtually all of the recommendations made by SIA and received our strong support. SIA testified in support of the legislation in both the Senate and the House.[1]

The compromise drafted at the end of the 101st Congress, under your leadership, along with Senators Bond, Leahy and Lugar also addressed a number of important recommendations made by SIA, particularly the margin and coordinated circuit breaker proposals. However, it did not contain any language relating to the issue of jurisdiction over stock index futures which was of vital importance to SIA. Nonetheless, in testimony before the Agriculture Committee earlier this year, SIA testified that the proposed compromise in the last Congress was an important first step in rationalizing the regulation of our capital markets. It was acceptable to SIA as far as it went, but we testified that it did not go far enough because it did not address the jurisdiction issue.

Swaps

The swaps provision of the original S. 207 was by and large satisfactory to SIA. While we had some qualms about the language concerning hybrids, it was generally unobjectionable, since it would have left our capital markets free to innovate and compete.

Title III of S. 207 as reported by the Agriculture Committee radically alters most of the key elements of that compromise. Oversight authority over margins would be granted to the Federal Reserve Board, but it could immediately delegate that authority to the CFTC without the 30-month trial period for Fed margin control envisioned by the original compromise in S. 207 as introduced.

Particularly great damage was done to the original thrust of the bill by the changes made to the swaps provision of the legislation. The new section lacks the clarity and objectivity required to enable U.S. participants to conduct swaps business in the United States and to compete in the international marketplace. It is particularly troubling that this provision, which was originally intended to create a workable exception for swaps free of many of the limiting provisions of the CFTC's 1989 Policy Statement Concerning Swap Transactions, is instead significantly more restrictive than the Policy Statement.

As reported, S. 207's swaps provisions are in two parts. Both parts rely on the definition of swap agreements set forth in the Bankruptcy Code as well as in S. 207 as introduced. The first part (proposed 4 (d)(1) of the CEA) provides for exclusion from the CEA for certain qualifying swap agreements. The second part (proposed 4 (d)(2)) mandates the CFTC to issue an exemption for certain other swap agreements under specified conditions. Both parts as drafted would undermine the existing swaps market and business by greatly increasing uncertainty and risk. Moreover, the existence of both an exclusion and exception may be read to create a negative inference insofar as excluded swaps would not be deemed to be futures contracts; whereas conceivably, exempted items might be.

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[1] testimony of Edward I. O'Brien, President of SIA, before the House Subcommittee on Telecommunications and Finance, May 3, 1990; testimony of John Bachmann, past Chairman of SIA, before the Senate Banking Committee, July 11, 1990; and testimony of Marc Lackritz, Executive Vice President, SIA, before the Senate Agriculture Committee, February 20, 1991.

The exclusion may well be intended to provide greater certainty, but the limitations on the exclusion dramatically undermine its effectiveness and, in fact, create vastly more uncertainty. The exclusion as written is so narrow as to define an illusory set of transactions. To be eligible for exclusion, the swap agreement must meet two criteria. The first is that "each party enters into the swap agreement to hedge or manage a business-related price risk." This criterion, which is significantly more restrictive than the Policy Statement's "line of business" test, ignores the nature of the market, making the exclusion unavailable to swap dealers (those banks, securities firms, and others whose business it is to offer swaps and manage the resulting interest rate or commodity price risk). Instead, this criterion would only apply when swaps are entered into between "end users" who are hedging or managing other business risks. The swaps business doesn't operate this way - swaps intermediaries (brokers and dealers) are integral to the operation of the market because the credit facilitation provided by intermediaries is necessary for the transactions to occur.

The second criterion necessary for the exclusion is that "each party reasonably expects to perform fully its obligations to make or receive payments at the time or times specified in the swap agreement." This provision requires an uncertain subjective evaluation of the intent of the parties entering into the swap. The criterion is intended to preclude termination and netting, two important risk reduction techniques that are encouraged by bank regulatory authorities. It will also hurt the competitiveness of U.S. firms by making them unattractive counterparties for the many participants, particularly non-U.S. banks and securities firms, who will be reluctant to provide any such certification as to their subjective intent.

The second part of the swaps proposal directs the Commission to exempt certain swap agreements. However, unlike S. 207, which included a mandatory provision requiring the CFTC to exempt swaps from all of the provisions of the CEA, the CFTC's proposal requires no exemption at all, but instead gives the CFTC discretion to exempt swap agreements "from <u>any or all</u> of the prohibitions and requirements" of the CEA. In addition, S. 207 as reported contains three substantive requirements for exemption not contained in S. 207 as introduced or the CFTC's Policy Statement.

The first requirement for exemption is that "each party to the swap agreement is an institutional participant" as defined elsewhere in the proposal to include certain financial institutions and corporations with net worth greater than $1 million. This requirement, while perhaps intended to be broad (since it includes registered floor brokers and floor traders), is generally very limited. Corporations and others much have net worth exceeding $1 million. Nowhere else in the world is it necessary to receive proof of a counterparty's net worth, evidence of which may not always be available or understood. Even if guaranteed by substantial companies or supported by other credit enhancements, corporations with less than $1 million of net worth would not be eligible. In addition, quasi-governmental entities like the IMF or the World Bank would not be eligible. Thus, the "discretionary exemption" would exclude many current participants in the market. Further, this $1 million net worth requirement would preclude insolvent companies and those in Chapter 11 bankruptcy or in workout situations from utilizing the swaps market to hedge their risks.

The second criterion for exemption requires that "the creditworthiness of each party to the swap agreement would be a material term of the negotiation of the swap agreement." While the CFTC's explanatory statement indicates that this provision is not intended to prohibit margin or collateral provisions, the criterion would appear on its face to embody a strict (if undefined) limit on such provisions. As a result, its intent is unclear. The criterion is also far too subjective to be workable and it is not clear whether it applies to the parties' master agreement or to each transaction under the master. In addition, the applicability of the section to options, where creditworthiness does not apply to the premium payor or to swaps with option features, such as caps and floors, is particularly unclear. Then too, where each side of a swap is a triple A credit, creditworthiness may not in fact be a negotiated term. The last criterion for exemption requires that "the swap agreement is not designed to and would not result in a trading market in the swap agreement." The term "trading market" is not defined. On its face, it would appear to prohibit completely a swap dealer from engaging in its customary business of making a market in swaps.

The overall effect of S. 207 as reported is that it creates confusion and uncertainty. Swap participants will be inclined to do business outside of the U.S. rather than answer intrusive questions about their business and face the uncertainty of their counterparty's eligibility under the CFTC's criteria. The imposition of congressionally mandated new and extraordinary requirements on swap participants creates new regulatory responsibilities for the CFTC and defeats the intent of the original framers of S. 207, who sought a statutory amendment on swaps to provide clarity and certainty for international and domestic participants.

We note for the record that some have called for an express exclusion for bank deposit account swaps and hybrid products structured as depository instruments. We are troubled by this primarily because of the negative inferences that might be drawn were certain types of products to be automatically excluded from the CEA, while others would have to rely on the exemption process. This could unnecessarily and unintentionally harm non-bank deposit products and the firms that engage in that type of swaps business.

Hybrids and Exclusivity

The hybrid and exclusivity portions of S. 207 as reported (Sec. 303) raise serious questions about the ability of American capital markets to compete in the future. The United States has traditionally had the broadest, most liquid, and most innovative capital markets in the world. After the imbroglio over the ambit of the CEA developed around the IPs products, a principal purpose of Title III was to resolve questions over hybrids and exclusivity which threatened to drive new product trading and development overseas. The original compromise contained in S. 207 as introduced, while imperfect, did at least resolve some of the legal ambiguities and uncertainty inherent in the status quo.

Here too, the new language in S. 207 as reported is a radical step backwards in a dramatic change from the original compromise. As reported, S. 207 codifies into law the position that all financial instruments that the CFTC determines to include any degree of "futurity" must be traded on futures exchanges unless a product (1) meets a misleading mathematical test that less than 50% of its value derives from the value of the commodity option or future commodities prices or (2) receives a written exemption from the Commodity Exchange Act from the CFTC.

Even that apparently "neutral" 50% of the value test would likely provide no real relief since the test would be determined by the CFTC, and under the existing CFTC analysis, new equity products with characteristics of both futures and securities are always viewed as futures. Thus, it is highly unlikely that there would ever be an equity related hybrid that the CFTC would determine meets the requirement for the 50% exception. Moreover; the descriptive language accompanying the ostensibly clear value test is very murky and would lend little or none of the certainty promised by the numerical standard. Ultimately what is a hybrid remains unclear given the overly broad reach of the defining language.

Were this provision to pass unchanged, a number of deleterious results would ensue. Innovation in American securities markets could be stifled; all hybrids having any element of futurity could be subject to regulation by the CFTC; issuers would bear the heavy burden of proving numerous factors to the CFTC. Exemptions (if granted) could be revoked; the exemptive process itself takes too long as it calls for a hearing with all of its cumbersome procedures and delays. Specifically, hybrid products with embedded futures would have to pass muster in an exemptive process that may well be too narrow to accommodate them. Issuers would still be subject to suits based on competitive considerations, thus chilling competition among securities and futures exchanges. American markets would thus remain at a competitive disadvantage in this area.

The process of raising capital could be inhibited by the costs of potential litigation, or even driven to overseas markets. The confusion and uncertainty that the original compromise was designed to reduce or eliminate would only be exacerbated by the additional court challenges that would inevitably ensue.

The reported legislation has additional unfavorable aspects which make its modification imperative. The SEC's ability to define a security is called into question by the legislation. For example, it could be read to give the CFTC jurisdiction over stock index options, other equity index products and perhaps, options on individual securities. Contrast this with the original Administration bill in the last Congress, S. 2814, which was intended to stimulate competition and innovation wherever possible. The current language seems designed to move in precisely the opposite direction by restricting innovation and competition in a series of existing and future products.

The exclusivity definition codified by S. 207 as reported is strengthened in its application to banking, securities and other financial instruments. That expansion definition of exclusivity is subject only to the occasional exceptions or exemptions granted at the sole discretion of the CFTC. Many new hybrid securities products would, like index participations, be effectively banned or driven offshore. Arguably, jurisdiction over the entire index option market could be transferred to the CFTC. The net result of these rewritten provisions might well be to stifle precisely the increased competition and innovation critical to future economic growth and prosperity. Whenever possible our laws should allow securities and futures instruments to be offered to investors free of unnecessary restrictions. Low cost capital can be achieved only by minimizing regulatory hurdles, litigation and uncertainty as to the lawfulness of innovative forms of securities and futures instruments.

Despite seemingly broad exemptive authority, a financial innovator would have to meet the heavy burdens of proving at least five factors “to the satisfaction of the CFTC.” One of the factors could even be read to give the commodities exchange a near veto over the exemption process by requiring that there be no material adverse effect on a future exchange’s performance of self regulatory duties.

SIA has worked long and hard on the panoply of issues in this very complex and crucial area. We are deeply troubled that the result of all the effort to date is a measure we regard as destructive of the swaps market and injurious to the United States capital markets as a whole. We stand ready and eager to work with you, your colleagues, and staff to correct the inadequacies in the legislation.

Thank you for your consideration of our views.

Sincerely

Gedale B. Horowitz
Chairman

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