Securities Industry Association
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April 7, 1994

Mr. Brandon Becker
Director, Market Regulation Division
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Brandon:

As we agreed at our last meeting, we are writing to set forth our thoughts on an appropriate framework for supervisory oversight of the OTC derivatives business, particularly as it is conducted by U.S. affiliates of registered broker-dealers. This letter is submitted on behalf of a group of SIA member firms[1] whose affiliates constitute the leading dealers in such OTC derivatives.[2]

As discussed in greater detail below, we believe that the OTC derivatives markets can benefit from a supervisory regime for U.S. affiliates of broker-dealers – not currently subject to direct SEC regulation – based on the following general framework to which we would agree to adhere on a voluntary basis:

- Reporting on a periodic basis to the SEC and/or other appropriate regulators sufficient to evaluate the risks undertaken by such firms and the methods utilized to control them;

- Developing industry standards to address investor protection concerns;

- Developing a process for assessing standards of capital adequacy based upon the risk evaluation models adopted by major dealers for their own use;

[1] The firms are Bear Stearns, C S First Boston, Goldman Sachs, Kidder Peabody, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Salomon Brothers.
[2] This letter does not address issues relating to broker/dealer affiliates whose primary business is commodity trading, or the commodity derivatives traded by such firms.

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- Enhancing financial statement disclosure to portray more accurately the risk profile of derivatives dealers, including market exposures arising from cash instruments and derivatives products; and

- Active regulatory assistance in industry efforts to reduce uncertainties regarding the legal status of transactions in OTC derivatives and other financial instruments.

General Propositions

Our view of an appropriate supervisory regime for OTC derivatives is based on certain general propositions as set forth below to which we subscribe:

1. OTC derivatives have already become a critical element in the global financial market, essential to many businesses and other enterprises in the management of risk, capital raising and investing. Accordingly, it is particularly important that supervision of this activity be conducted in a manner that is flexible and does not stifle the innovation that provides true economic value to the financial system and that has been the basis for the success of U.S. firms in this highly competitive and international enterprise.

2. OTC derivatives dealing is primarily oriented to a sophisticated institutional clientele. Transactions in OTC derivatives are privately negotiated and not automatically transferable. Prices in this market are not relied upon by the general public for making economic decisions.

3. To be competitive, OTC derivatives dealers must take significant amounts of unsecured credit risk. For that reason, the OTC derivatives business is particularly sensitive to, and dependent on, both credit ratings and the market's own critical assessment of a firm's creditworthiness and management integrity. In this sense, the business is more closely related to the market-intermediary function associated with a banking business than it is to the securities dealing/trading function of a securities business. Accordingly, the level of asset liquidity required of securities dealers cannot and should not be expected of OTC derivatives dealers. Nevertheless, OTC derivatives dealers can, however, expect to have a high level of market risk liquidity (an ability to off-set risks through new transactions in OTC derivatives or other financial instruments) and a high level of funding liquidity (enabling them to withstand differential cash flows resulting from timing differences and the variety of collateralization arrangements for different financial instruments).

4. The risk management tools required to manage prudently a dealing operation in OTC derivatives are also valuable for the prudent management of dealings in securities and other financial instruments. Accordingly, the continuing development and refinement of those tools by OTC derivatives dealers assists affiliated broker-dealers in managing the risk of their activities.

5. As a result of adherence to sound credit evaluation practices and the development of sophisticated risk measurement techniques, OTC derivatives dealers have functioned without a serious incident arising from mismanagement of either market or credit exposures.

Public Policy Issues

Beginning with these general propositions, we recognize that the rapid growth of the market in OTC derivatives, and the extensive participation in that market by U.S. affiliates of broker-dealers not subject to direct supervisory oversight, may raise public policy issues the resolution of which could benefit the global derivatives market:

1. In the case of major dealers, regulators have voiced concerns that require access to more specific and current information than would be available even through an enhanced regime of general reporting. These concerns include the possibility, *whether or not truly likely,* that:

a. Hedging of OTC derivatives in the cash and exchange-traded futures or options markets, on which the economy relies for price discovery, could have significant price effects in the cash and futures markets;

b. Concentrations of unsecured credit risks between dealers, or between dealers and their largest customers, could be of a sufficiently large magnitude that they pose a risk that a default by one dealer or customer could create a serious capital, earnings or liquidity problem for another dealer (this item, and the preceding item, are two aspects of "systemic risk");

c. Dealers and other participants in OTC derivatives may not have the internal risk management systems and controls required to monitor and manage the risks of their activities;

d. Dealers and other participant in OTC derivatives activity may not have secure access to funding in the event of temporary setbacks in their activities or temporary cash flow difficulties caused by timing differences or variations in collateral requirements between different instruments; and

e. Dealers and other participant in OTC derivatives may not have sufficient capital to withstand large credit or market losses without suffering insolvency or major disruption of other activities.

2. Regulators with a mandate to ensure investor protection, such as the SEC, are properly concerned that unscrupulous dealers may persuade unsophisticated investors to enter into transactions without sufficient information or in a manner inconsistent with a retail customer's expectations of good investment advice.

3. Accounting policy has not kept pace with the developments in financial markets, including the widespread use of OTC derivatives. As a result, financial statement users are not able to derive an accurate picture of the risks inherent in the operations and commitments of a financial institution from the composition of a balance sheet as presently presented. The lack of a comprehensive presentation of the risks associated with our business has caused understandable uncertainty and anxiety on the part of the equity markets, creditors, regulators and others concerned with the financial health of a reporting organization.

4. Market participants recognize that the legal status of contractual arrangements relating to financial instruments – including OTC derivatives – do not always keep pace with the development of those instruments. Nor does insolvency law always recognize the importance of enabling market participants to achieve liquidity in the event of default. Industry groups have worked with regulators and directly with legislators to address these issues, but much work remains to be done.

Recommendations

Our recommendations parallel the concerns set forth above, and would, we believe, serve to address adequately those concerns in a constructive and practical manner. In view of our belief that the regulatory model embodied in the Securities Exchange Act of 1934 and the rules adopted pursuant to it do not provide a useful model for developing a supervisory mechanism for the dealers in this market, we propose a framework based on the voluntary participation of market participants in partnership with the SEC and other appropriate regulators. We believe that putting a voluntary structure into place would be more efficient and productive than developing other supervisory structures. This framework would have the following elements:

1. A series of more detailed and timely reports to be designed in partnership with the SEC and other appropriate regulators to address the issues described in the list of concerns set forth under the heading of “Public Policy Issues” above. They would include relevant information such as:

a. Reports on positions hedged in exchange-traded instruments and the nature and size of those hedges;

b. Reports on large concentrations of unsecured credit exposures, including the nature of the counterparties, their credit standing and the term structure of those exposures;

c. Reports on the adequacy of internal systems and controls, including supporting reports from internal and external auditors;

d. Reports on funding arrangements;

e. Reports on how the organization determines the adequacy of its capital in relation to the risks incurred in its business. This would entail reviewing the tools used by management and rating agencies to determine capital adequacy at the level of creditworthiness at which the particular enterprise has chosen to operate. Ideally market participants and regulators could agree on a methodology for auditing these tools, which include sophisticated mathematical models that may vary from firm to firm but which produce results the similarity of which are validated through the marketplace;

f. Additional access to information would be given to the SEC and other appropriate regulators on an "as needed" basis.

2. Development of standards of capital adequacy for dealers in OTC derivatives based upon the dealers' own risk evaluation models appropriately verified and subject to stress testing (as generally described in our response to the Concept Release) based on the review described in paragraph 1.e. above.

3. Dealers in OTC derivatives, again working closely with the SEC, should develop guidelines to address investor protection concerns. Individual investors, and others who may have a right to rely on dealers to recommend only appropriate investments, should be able to have similar protection with respect to OTC derivatives. All participants in OTC derivatives should have access to information regarding the risks, and for unsophisticated investors, measures may be necessary to ensure that the necessary information is being conveyed.

4. An industry initiative, working in close cooperation with the SEC and the accounting profession, should be undertaken to overhaul the financial statements of dealers in and significant users of financial instruments to provide truly useful information regarding the risks entailed in the commitments to those instruments held by the disclosing institutions.

5. The SEC and other concerned regulators should work actively with derivatives dealers to design legislative and regulatory measures to help insure legal certainty of transactions in financial instruments.

We hope that you will agree that this proposal serves as an appropriate framework for a supervisory structure with respect to OTC derivatives. We wish to continue a constructive dialogue with you to develop the details necessary to implement this framework.

We look forward to discussing our framework with you and your colleagues.

Sincerely,

Jeffrey L. Seltzer
Chairman,
Swap & OTC Derivative Products
Committee

cc: Simon M. Lorne, Esq.