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**REMARKS OF  
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U.S. SECURITIES AND EXCHANGE COMMISSION**

**DERIVATIVES: REGULATORY OVERSIGHT FOR  
PLAN SPONSORS AND ADVISORS**

**CURRENCY EFFECTS IN  
INTERNATIONAL INVESTMENT PORTFOLIOS  
*First Annual Symposium***

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The views expressed herein are those of Commissioner Beese and do not necessarily represent those of the Commission, other Commissioners, or the staff.

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*Justice Douglas once said, "Government should keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used." This adage is particularly applicable to the modern marketplace. Since the formal inception of the marketplace over two hundred years ago, the markets have changed considerably. Technology has revolutionized trading. Orders are executed within seconds. Markets are interlinked globally. Market products are also fluid. Instead of investing in plain stocks and bonds, investors are purchasing hybrid products whose values are derived from the price of some underlying asset.*

*As the marketplace and its products become more sophisticated and complex, the public naturally becomes uneasy about what it cannot understand. Unfortunately, Congress and regulators can sometimes respond to this unease by overreacting and overregulating the perceived evil.*

*My fear is that this may be the case with respect to derivatives. One of the greatest challenges facing the marketplace today concerns the recent explosion in the use of these products. From their first modern incarnation as shares in pools of home mortgages, derivatives now encompass myriad forms from interest rate swaps to interest-only strips. Growing at a rate of 40 percent or more per year since 1986, the derivatives industry now constitutes an estimated \$7.5 trillion market.*

*My talk focuses on the best way to manage risk in this market - one of the most dynamic markets today. I believe that the best way to control risk, as well as the public's perception of that risk, is through industry self-policing. The clearer it becomes to the public that derivatives will not have a disproportionately negative impact on the market, the more regulators can appreciate the true dynamics of the derivatives marketplace and respond in a manner that will not hinder the effective operation of the markets.*

### **IMPACT ON THE MARKET**

*Derivatives are becoming an increasingly important source of revenue for financial entities. According to the Office of the Comptroller, 626 banks had positions in derivatives as of the end of last September. In its annual report, Chemical Bank disclosed that derivatives accounted for approximately 40 percent of its \$1.1 billion in total trading revenue last year. Merrill Lynch's recently issued annual report revealed that its revenue in 1993 from derivatives was*

*greater than from stocks. Its revenue from trading swaps and derivatives rose to \$761 million, a 57 percent increase from 1992.*

*Derivatives are so attractive because of their versatile uses. They can be used to hedge a portfolio against loss, as well as to enhance the return of mutual funds. Municipalities have found that using them can lower financing costs. For instance, New York City's deputy comptroller for finance estimates that derivatives, primarily interest rate swaps, have saved the city \$10.8 million in financing costs.*

*However, increased use of these instruments is raising concerns about their impact on the stability of the financial markets and the health of the banking system. During periods of market stress, concerns arise with regard to the possibility of a "ripple effect" and the impact of derivatives activities on the liquidity of the cash market. Under a potential ripple effect, the increased use of derivatives could lead to the failure of one or more derivatives dealers. This would, in turn, "ripple" throughout the OTC derivatives market for broker-dealers and participants.*

*Similarly, in an extreme market stress environment, the liquidity of the nation's equity markets could be strained by the sell-off of stocks and futures by derivatives dealers trying to adjust their hedges to accommodate rapidly changing market risks. Some commentators are blaming the recent sharp drop in bond and stock prices to traders who borrowed heavily to buy securities and then liquidated their holdings when interest rates rose.*

*Moreover, recent reports of billion dollar losses resulting from derivatives usage have not improved public confidence in these markets. For instance, the press reports that Metallgesellschaft posted a \$1.35 billion loss late last year on its U.S. oil derivatives trading.*

### **CONGRESSIONAL INITIATIVES**

*These financial press reports have done much to fan the flames of public concern over use of derivatives. Congress has become so concerned lately about the impact of derivatives on the markets, that several legislators have raised a clarion call for action. Last January, Representative Leach introduced a bill to create a Federal Derivatives Commission to oversee this market. Just two weeks ago, committee*

aides to Representative Henry Gonzalez announced that he intends to introduce a bill on derivatives later this month. Next Wednesday, Representative Gonzalez will hold hearings to discuss the risks imposed on the markets by hedge funds, some of which are the largest users of derivatives.

### REGULATORY INITIATIVES

In addition to Congressional initiatives, regulators have focused their attention on overseeing the derivatives market. Since Gerry Corrigan sounded his warning approximately two years ago, representatives of the Board of the Fed, the CFTC, the Treasury, the SEC and the New York Fed have met regularly to discuss derivatives regulation as part of the Working Group on Financial Markets. The Working Group is quite concerned about enhancing the disclosures available for dealers and end-users both in the United States and abroad. It also is attempting to devise a uniform international format for reporting derivatives activity to regulators. Finally, the Working Group is concentrating on internal controls for the different types of dealers present. Historically, bank regulators looking at banking institutions have had different concerns than securities regulators looking at securities firms. With both entities now actively participating in the same market, regulators should compare notes to see how their requirements stack up against other objective standards, such as the Group of 30 Report.

In addition to these cooperative efforts, the SEC has been taking steps on its own initiative to address public concerns about the derivatives market. Last May, the SEC asked for public comment on a broad range of issues relating to the appropriate capital treatment of derivative products under the Commission's net capital rule. Last month, we proposed amendments to the net capital rule to allow broker-dealers to use option pricing models to determine haircuts for listed options and related positions. These amendments represent a switch to the more sophisticated portfolio approach to calculating capital.

These amendments are just the first of several steps to update the rule to provide prudent levels of capital consistent with current derivatives activity. We also are considering ways to incorporate OTC options in the pricing model strategy. This is obviously a more difficult task, as OTC options often lack the same degree of

*information regarding pricing and liquidity that are the requisite model inputs.*

*The next planned step will be to establish market risk charges for interest rate swaps and currency exchange agreements. We already have a tentative draft of a grid of charges that would integrate these swaps into a framework that would also include government securities. We currently are working with the SIA Capital Committee to assess the applicability of this approach. I am hopeful that we can have a proposed rule in the next few months. With respect to currency exchange agreements, we have work in progress based on industry proposals, although much more will need to be done.*

### **INTERNATIONAL REGULATION**

*Derivatives are not just a "hot" topic domestically. Regulators are focusing on these issues in the international context. Just last month, the SEC, the CFTC and the British Securities and Investments Board took the first formal step toward international cooperation in the regulation of the derivatives market. We issued a Joint Statement that establishes an agenda for oversight of the OTC derivatives market.*

*Some of the goals set forth in the Joint Statement are regulatory in nature. For instance, the three agencies have agreed to enhance the existing arrangements for the exchange of financial and operational information regarding the major securities and futures firms they each regulate. The motivating force behind this arrangement is simple: You can't regulate effectively what you don't know. If our goal is to address the potential for systemic risk, we must first know its source and its size.*

*Another regulatory goal is the establishment of capital standards that encourage incentives for good risk management. The agencies are continuing to review and modify, as appropriate, their capital standards, in the hopes of creating prudent risk-based charges for firms.*

*The Joint Statement also addressed netting arrangements, and their impact on capital standards. Legally enforceable netting arrangements are important to market players who are trying to control and manage their counterparty credit exposure. After all,*

*credit risk can be just as dangerous as market risk. The agencies agreed that applicable capital standards should reflect the risk-reducing characteristics of legally enforceable netting arrangements.*

*In addition to these regulatory goals, the Joint Statement addressed what I term as market or industry goals. Among these goals are the desire to promote the development of sound management controls, to encourage greater standards for customer protection, to improve accounting and disclosure standards and to establish a framework for multilateral clearing arrangements.*

*Although these regulatory initiatives will improve the stability of the derivatives market, I believe that the industry and the market participants hold the key to meeting the concerns that have prompted the regulators to call for action in these areas. The best way to control the systemic risk presented by the increased use of derivatives is for the industry itself to take bigger steps to self-police and self-discipline market participants. Systemic risk control begins with market participants controlling risk at the firm level. This is why the Joint Statement spotlights this issue, and why the agencies involved are committed to working with industry groups to improve systems for monitoring and controlling derivatives activities.*

*Reading between the lines of the Joint Statement, I think it is fair to say that the SEC is committed to following up with the appropriate SRO's to see if some type of industry code of conduct is feasible, as others have suggested. Clearly, we are concerned about suitability and whether the "know thy customer" rule is being applied in the derivatives marketplace. If the industry moves forward to address these concerns, then both Congress and the SEC will have less to worry about.*

*Similarly, the Joint Statement calls for consideration of a regulatory framework to apply to clearinghouses and other multilateral arrangements OTC derivatives transactions. This represents another area where the industry can act and suggest a solution, rather than react to a government requirement.*

### **ROLE OF SENIOR MANAGEMENT**

*For the industry to effectively police this market, however, it must make sure that the users of derivatives fully understand these products. According to a survey recently released by the Group of*

30, the boards of many dealers and users of derivatives do not have this firsthand knowledge. Approximately 36 percent of the dealers and end-users surveyed had some concern that senior management had an insufficient understanding of derivatives. Approximately 43 percent of those surveyed had some concern regarding over-reliance on a few specialists. The gulf between front and back office professionals was an area of concern for approximately 41 percent of those surveyed. As the G-30 report indicated, senior management must not only "pay attention to firms' derivatives activities," but also must develop a thorough understanding of the products, the risks their firms assume because of this activity, and the manner in which those risks are managed and controlled.

In addition to senior management taking an active role in overseeing this business, board audit committees should ensure that the firm's internal and external auditors are asking the right questions. This inquiry should include the following:

1. Identifying a group in the firm primarily responsible for risk management
2. Determining whether this group is separate from the traders who are incurring the risk
3. Determining whether this valuation group arrives at the assumptions in their pricing models independently or receives key input data from the originator of the trade
4. Determining whether internal controls and information systems are reliable and working well
5. Determining whether credit exposure to specific counterparties is being marked to market, and finally
6. Determining whether there is centralized risk management for the holding company and its subsidiaries.

### CONCLUSION

As derivatives devour an ever increasing share of the marketplace, regulation, by either the industry or government, becomes a certainty. To ensure that the well-intended efforts of regulators do not unduly burden the market, market participants must

*take an aggressive role in controlling the risk, and the public's perception of the risk, in this market.*

*Indeed, as the Commission's recently issued Market 2000 Study points out, competition and economic forces, within a stable regulatory framework, should determine appropriate market practices. Investor confidence in the integrity of the rapidly changing markets can only be improved by a close working dialogue between participants in this dynamically evolving market and those entrusted with regulatory oversight responsibilities.*