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U.S. SECURITIES AND EXCHANGE COMMISSION**

**DERIVATIVES AT THE CROSSROADS**

**KEYNOTE ADDRESS BEFORE  
THE TWELFTH ANNUAL OPTIONS INDUSTRY CONFERENCE**

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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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Recently, I came across a book by a Dutch author, Joseph de la Vega. The book described the workings of a foreign stock exchange, focusing primarily on the trading side of the market. De la Vega wrote about the bankers, the brokers, and the dealers who participated on the exchange. He explained how they traded stocks, futures, options, and how they used cash-settled instruments and margins. He wrote about their sophisticated trading strategies, including the when-issued market, short sales, and straddles. He also described a clearing system that incorporated netting.

Indeed, this book could serve as very useful reading for many in Washington and in the media, who now are grappling with the whole issue of derivatives. Of course, those taking the time to read this book must understand that it describes the Amsterdam Stock Exchange, and that de la Vega wrote this book in 1688.

I tell you this story not to impress you with the breadth of my library, but to emphasize that even today's more esoteric products have their roots in the earliest organized trading markets. It seems that the Amsterdam Stock Exchange, the first organized stock exchange in the world, also gave birth to many of the practices and customs that characterize modern markets.

I suppose it is true that the more things change, the more they stay the same. Perhaps nowhere is this more true than with financial markets. Throughout history, we've seen that these markets operate on the same basic principles: Every transaction involves the same fundamental analysis of risk versus reward.

It's important to keep these lessons in mind as we evaluate new markets and products, such as the current state of the derivatives market. As I watch the recent media frenzy over derivatives, it appears that some have only recently discovered that markets go up as well as down; and that anytime markets move, some people make money, and some people lose money.

Of course, there are surprising revelations with the explosive growth in the use of derivatives. Some of the people losing money now are among of the best known investors and corporations in America, and the sheer size of these losses does make for great headlines. Moreover, the financial products and strategies generating these losses are complex and sophisticated, and there are no neat sound-bite explanations to justify why these losses are occurring.

The bottom line for many is simple: More and more people are losing more and more money in our financial markets, doing things

**that we don't exactly understand, and something must be done to make our markets safer. As the cover of Time magazine recently trumpeted: "High-tech supernerds are playing dangerous games with your money."**

**This type of reasoning is not only simplistic, but dangerous as well. In Washington, regulators and legislators are finding themselves under increased pressure to act. And with the release of the GAO report on derivatives expected on May 18, this pressure will only get stronger.**

**No doubt, certain steps should be taken, and the SEC, as well as other regulators, have made good progress over the last two years. A lot more needs to be done, particularly with regard to capital adequacy, accounting and disclosure rules. At the SEC we are committed to continuing our efforts in each of these areas.**

**But reaching for quick-fix regulatory or legislative solutions based on hype and headlines could have a profound impact on our financial markets. The fact is that the majority of people do not have a good grasp of what derivatives are, what they do, and the extent to which they are already ingrained in our society. Without an adequate foundation of knowledge, we cannot possibly hope to construct a regulatory system capable of maintaining the benefits we currently enjoy, while protecting us from the dangers that do lurk out there with the misuse of derivatives.**

**We in this room each have a role to play if such a system is to become a reality. On the industry side, a massive educational effort is needed to allow everyone -- whether regulators, legislators, end-users or individual investors, and perhaps even magazine cover story writers -- to understand and appreciate the nature of the beast we are dealing with. Public policy cannot address what it fails to comprehend.**

**Equally important, on the government side, we must re-assess our rules and regulations to see where they can be made more effective and more efficient. We must encourage our markets to work for us, rather than against us.**

**For example, more and more it seems that the restrictive nature of our rules has forced the development of new and innovative products to occur outside of our regulatory system. As demand grows, this quasi-black-market for financial products mushrooms, but**

**our regulated markets are too often shackled and unable to respond and compete in a timely fashion.**

**History has shown time, and time again, that free and open markets are the surest way to eliminate the dangers posed by black market trading. Indeed, the introduction to the Market 2000 report states as one of its guiding principles that competition and innovation in the provision of trading services should be encouraged. If we can provide end-users in the OTC derivatives markets with alternatives in the listed derivatives markets, this healthy competition will naturally erase many of the dangers so many have written and worried about.**

**So far, it appears that both the industry and the SEC are willing to accept their respective roles. Most certainly, a successful industry-led educational effort on the prudent use of derivatives will make the SEC's job that much easier.**

**People need to understand exactly what derivatives mean to their daily lives. Some of the concern about this market undoubtedly results from the fact that there is a mystique to these products. After all, they are complex and often based on mathematical models that the average layman can't conceptualize. Moreover, there seems to be a common misperception that we can make our markets safe again by simply running these "outlaw" products out of town ... or off-shore.**

**But far from outlaws, derivatives have proven themselves indispensable to our modern society. For example, affordable home mortgages and variable mortgage rates -- both made possible through derivatives. The same is true for the special car loan rates now widely offered, and the greater availability of student loans. Indeed, in an age of incredibly volatile global financial markets, derivatives make stable consumer credit markets a reality. Most people can readily understand that without widely-available home mortgages, our economy would be in a world of trouble; now is the time to explain that without derivatives, our consumer credit markets would be in a world of trouble.**

**People must realize that derivatives are not simply leveraged speculative trading instruments, but that they have real-world uses. I'm not sure that some understand that there are two sides to the derivative equation, and that the level of risk involved is wholly dependent on which side of the equation you are on.**

**Derivatives can be very useful to help end-users hedge their risk by laying it off to others, making deep, liquid and stable credit markets possible. Of course, the risk laid off does not disappear, and how that risk is handled is a major concern. The second prong of the industry educational effort must be to convince the public and those that oversee our markets that these risks are just that— risk; and that there will be winners and losers with each trade, but within reason, the risk involved is identifiable and under control. This is a tall order. Many in Congress in particular have expressed grave concern over the expanding use of derivatives, and the specter of past financial disasters weighs heavy on their minds.**

**The S&L crisis is most frequently mentioned when discussing the possible dangers posed by derivatives. Of course, players in the derivatives markets dismiss these comparisons outright as having no real basis in fact. One of the classic problems confronting S&L's — the asset/liability mismatch of lending long and borrowing short — has been substantially reduced through the use of derivative products.**

**Nevertheless, the ghosts of disasters past remain a force to be reckoned with. When I testified before a Congressional panel concerning derivatives last October, several Representatives present invoked some comparison to the S&L crisis. And just last week, Comptroller of the Currency Ludwig spoke at length about how proprietary derivatives trading by banks may cause losses for taxpayers in the same fashion that poor investments by S&L's caused huge losses. Unless these perceptions can be changed, the likelihood of federal legislation over the entire derivatives marketplace — including both Exchange-traded and OTC derivatives, and trades that hedge as well as those that make market bets -- remains a distinct possibility.**

**Against this backdrop, the industry must fill the informational gaps that exist, focusing on the consumer benefits and individual investors, and moving on to more sophisticated users as well. Unfortunately, given all the recent stories concerning multi-million dollar losses at certain hedge funds, a few mutual funds and a handful of U.S. corporations, the road to be travelled will not be easy.**

**I am pleased to see that such educational efforts are well under way from all segments of the derivatives marketplace. The Futures Industry Institute, the International Swap Dealers Association, and your own Options Industry Council, to name a few, have each initiated drives to help enlighten and inform. Wayne Luthringshausen,**

**Chairman of the Options Clearing Corp. will be making a presentation about the Options Industry Council program, so I will not describe the details here. Suffice it to say that I applaud the efforts to concentrate on both brokers and investors, so that the message is carried all the way down the line.**

**I also applaud the approach taken by ISDA. It has taken the tack that good management and good disclosure are two keys to encourage the prudent and safe use of derivatives. I couldn't agree more. As the G-30 report highlights, the real issue is not how regulators regulate, but rather how dealers and end-users manage the risk they are accepting.**

**ISDA has published and distributed a booklet entitled "Guidelines for Operations Practices," which recommends procedures and practices for dealers and end-user financial institutions to consider when engaging in derivatives activities. I think its important to remember that derivatives do not cause losses, people do.**

**Moreover, through good disclosure, we can eliminate the shock factor that currently accompanies public announcements of derivatives losses. Shareholders have a right to know their exposure to material risks, without reading about it for the first time in a newspaper. The SEC is focusing more attention in this area, and the FASB has recently proposed new rules that will also help the cause. These rules require companies to disclose more information about their derivatives holdings and their relative risk. The proposal would also require more discussion of a company's goals in holding or selling derivatives, as well as its trading strategies.**

**The industry's efforts to educate the public in general, and those that participate in the derivatives markets in particular, should go a long way towards helping focus the policy debate over how best to handle the growing presence of derivatives in our markets. True to my SEC background, I'm hopeful that when all is said and done, we as a society will reach a fully informed decision concerning derivatives, not one based on last week's headlines or this week's moves in our financial markets.**

**Of course, my preference would be for a market-based solution. In fact, in some ways, the recent derivatives losses reported in the press have a silver lining. To the extent that these reported losses have been caused though excessive leverage or over-speculation, our recent volatile markets have once again imposed discipline on these**

**activities. Speculation does not become over-speculation until losses result; otherwise, it's not speculation, but in hindsight, a wise investment.**

**Placing the recent losses in the public spotlight serves as a proactive reminder that there is a difference between hedging, sound investing and over-speculation. These losses have certainly caught the attention of boards of directors and senior management across the country, and have already caused end-users and dealers to re-evaluate their derivatives usage and their systems of internal control. From where I sit, that is a very good sign.**

**Our markets have always served to rein-in unwarranted speculation, and will continue to do so if we let them work. One problem in the derivatives marketplace is that too often antiquated regulation gums up the efficiency of our market mechanism.**

**As I mentioned earlier, many derivatives products are originated outside regulated entities and markets because regulations make in-house development impossible or impracticable. At the SEC, we are trying to remedy this problem by bringing our regulation up-to-date with the current market environment.**

**For example, we are trying to create prudent risk-based capital charges for derivative products under the Commission's net capital rule. In March, 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. The amendments represent a switch to the more sophisticated portfolio approach to calculating capital.**

**These amendments are just the first of several steps to update and revise the rule and provide prudent levels of capital consistent with current derivatives activity. At the same time we have these new haircut rules out for comment, we also are considering how to incorporate OTC options into the pricing model strategy. Obviously, this is a much more difficult job, as OTC options often lack the same degree of information regarding pricing and liquidity that are the requisite model inputs.**

**But this difference between listed options and OTC options is important for other reasons. I believe that one problem many end-users face in the derivatives markets is a lack of choices. The simple fact is that it takes so long for listed products to be approved by the**

**SEC that end-users often find they have no alternative but to go to the OTC markets.**

**Don't get me wrong. I'm not here to criticize customized OTC products. But the success of flex options to date demonstrates that end-users are willing to trade some degree of customization for the benefits derived from the lesser credit, pricing and settlement risks associated with listed products. If more of these types of products were available, perhaps more end-users would follow suit. Maybe some would, maybe some would not; but that would be a market decision, not one based on regulatory inequities. We need to give boards of directors and senior management real choices if we hope to reap the advantages that a competitive marketplace offers.**

**We can enjoy these advantages if we can level the playing field between exchange-traded and OTC derivatives. While many factors drive participants to one market or the other, the SEC can do more to encourage greater competition. For example, new exchange-listed products can take up to one year to get through an SEC review; but trading committees at firms can approve OTC derivatives in a week, if not a few days. That discrepancy serves neither our markets nor its participants well, and I would like to lessen its impact.**

**The Division of Market regulation recognizes and appreciates the problems caused by unlevel playing fields. In fact, the Market 2000 report makes recommendations to have routine procedural and administrative modifications by SRO's effective upon filing, to eliminate unnecessary delays.**

**The more pressing concern, however, is the time it takes for new product approval. The Division continues to work towards developing generic standards for as many areas as possible, in hopes of abolishing the need for tedious product by product reviews. The goal is to set out the general criteria to be met, so that individual products fitting into these guidelines could be approved upon filing, or perhaps, even without filing.**

**For example, the guidelines for options on ADR's and options on country funds are already in place, and we currently have a proposal out for comment for narrow-based index options. This proposal should be approved within the next month or so. My hope is that this trend can be continued, to the benefit of investors and our capital markets.**



## **Conclusion**

***The faster we can inject safe, innovative products into our markets, the faster the competitive forces of our market can work to naturally discipline our marketplace. If we can make the regulatory process operate more efficiently, our markets will also operate more efficiently. Flex options were not invented in Washington, and neither will the best multilateral netting system for OTC derivatives, no matter how many policy wonks are assigned to the task.***

***As the Dutch discovered so many years ago, markets do their job very well, if you let them. And just as the Dutch looked for ways to manage and control risk in the first organized markets, so that struggle continues today.***

***For me, goal one is to let the markets work, and if derivatives are what investors want, we must structure our regulatory system to encourage the markets to satisfy this demand. Investors have clearly demonstrated they will get their derivatives either one way or another, and by forcing derivative activity outside our regulatory system, we lose the protection that that system provides.***

***From my vantage point at the SEC, it seems each day we lose a little bit more of our regulated markets to OTC derivatives, off-shore funds, and overnight trading. The SEC recognizes that competition among and between markets produces many of the new products and new technologies that benefit investors, and this competition must be encouraged by leveling the regulatory playing field as efficiently and expeditiously as possible.***

***Legislators, regulators and the public at large must be educated so that they understand that there is nothing mysterious to fear from derivatives, as long as their nature is fully appreciated and their usage is prudent and fully disclosed. A heavy-handed tax or quick-fix legislation is not the answer. Efficient markets and fully informed market participants are the answer, and the more effort put forth to reach these goals, the safer we all will be.***

***And as a country, we will keep intact the inalienable right of corporations and individuals to lose money. Because if we lose that right, making money will be rather tough indeed.***

***Thank you.***