REMARKS OF

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OTC DERIVATIVES: KEY REGULATORY DEVELOPMENTS IN THE U.S.

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Next month, the world will celebrate and remember the 50th anniversary of the Normandy invasion of June 6, 1944, that began the liberation of Europe during World War II.

I certainly do not intend to minimize the importance and significance of that amazing and triumphant moment in world history, but as I stand before you today, I cannot help but think some of the same thoughts that must have been running through the minds of more than a few British and U.S. generals on June 5, 1944.

Tomorrow, the General Accounting Office of the U.S. Congress will issue its much awaited report on derivatives and the need for derivatives legislation in the U.S. Will this report change the derivatives world in the same way that the Normandy invasion changed world history? Perhaps, perhaps not. But without question, there is no way to predict how the public, the regulators and elected representatives in the U.S. will react. Much like asking the generals to predict the outcome of the invasion as they watched the troops and supplies mass on the English coast almost fifty years ago, it would be quite a bit easier to answer your question in two weeks, after the fact, than today, before the onslaught begins.

That being said, let me make my best efforts to answer the question at hand, and tell you where I think derivatives regulation is headed in the States, and what forces are driving the debate.

<u>GAO Report</u>

Fortunately for the free world, the press kept secrets better in 1944 than it does today. Already, newspapers in the States and Europe are full of stories detailing what the GAO report will state. Although it is hard to say how accurate these reports are, they all do suggest that more regulation, rather than less, will be the theme of the day. The release of the GAO's long awaited study is expected to fuel the mounting pressure in Washington for legislation on derivatives, and will set the framework for the debate on this issue. If recent press reports are true, the GAO report could spawn legislation that will expand the SEC's role from oversight of disclosure statements to wholesale regulation of U.S. corporate activities. The SEC could end up being a <u>de facto</u> member of every company's board of directors.

Press reports indicate that the GAO report will recommend increased regulatory oversight in several areas. For instance, the report is expected to recommend regulation of all major OTC derivative dealers, including currently unregulated securities and *insurance firms. The report also is expected to recommend that the SEC require independent audit committees and public reporting on internal controls for major end-users of derivatives. In addition, the report is expected to recommend that FASB adopt accounting rules to enhance disclosure of derivatives activity, and to encourage continued efforts by U.S. regulators to work with international authorities to harmonize derivatives regulation.*

Another purported concern of the GAO report is the development of adequate capital standards to cover OTC derivative risks. In particular, the press reports that the GAO believes that existing capital requirements for banks do not adequately address the legal, operational or market risk of derivatives use. To address these concerns, the GAO report is expected to recommend expanded legal and enforceable netting requirements as one way of reserving additional capital against possible losses.

<u>Congressional Initiatives</u>

The GAO report comes on the heels of already intense Congressional scrutiny in this area. Just last week, Congressman Markey's Telecommunication and Finance Subcommittee held the first of three hearings on derivatives. The hearing touched on issues that are expected to appear in the GAO report, such as the need to increase federal supervision of brokerage firm affiliates that deal in derivatives, and to improve disclosure.

If nothing else, the hearing underscored the wide range of disagreement on how this market should be regulated. While Congressman Markey expressed concern over the need for suitability or sales practice standards for derivatives, especially with respect to municipalities and other possibly less sophisticated investors, several former regulators uniformly testified at the hearing that additional legislation is unnecessary. Most notably, Gerry Corrigan, who sounded the first alarm on this issue over two years ago, reassured the committee that significant progress has been made to address concerns about derivatives products.

Although Congressman Markey's subcommittee has not decided yet whether to pursue a derivatives bill this year, the House Banking Committee is drafting a bill to cover bank derivatives activities, which it hopes to pass this summer.

The current concern about derivatives is in some ways a backlash to the recent savings and loan debacle in the U.S. Driving the debate are memories of the political careers wrecked on the rocks of the S&L crisis. This may be leading some to see mirages of potential crises, and reacting as if these mirages were real. It is not a crisis when the market imposes discipline on those corporate treasurers who make mistakes betting on the market. There are voices of reason, however. As Alan Greenspan suggested last week, although derivatives may increase the risk that a financial crisis will spread more quickly throughout the markets, derivatives "are part of an evolving portfolio risk management system." Instead of seeing derivatives as simply exotic new products, he sees them as part of the evolution of risk management.

Indeed, the real risk with derivatives is not with the products themselves. Rather, the risk lies in the suitability and pricing practices of dealers, and with how end-users use the products. Only last week, the press reported that Air Products and Chemicals, Inc. announced a pre-tax loss of $96.4 million on five derivative contracts. According to its chief financial officer, the company's losses came about because of management's failure to understand the risks associated with the contracts, and the risk models on which it relied. This case demonstrates that if Fortune 500 companies intend to use their treasury operations as profit centers, they need to appreciate fully the inherent risks involved.

By increasing their understanding of derivatives and by taking steps to regulate themselves in this area, end-users may be able to forestall sweeping regulatory oversight. The SIA recently sent a letter to the SEC on behalf of eight of the largest U.S. securities firms urging industry self-regulation of OTC derivatives. Under this proposal, securities firms would provide voluntary periodic reports on their derivatives activity with the SEC that would permit regulators to evaluate the risks faced by these firms, as well as the methods used to control these risks.

ISDA has also been outspoken in its belief that legislation would "create inequities" in the derivatives marketplace. It has published and distributed a booklet entitled "Guidelines for Operations Practices," which recommends procedures and practices for dealers and end-users to consider when using derivatives.

Regulatory Initiatives

In addition to these industry initiatives, the SEC has made some headway in addressing some of the concerns that are expected to be raised by the GAO report. For instance, we are trying to create prudent risk-based capital charges for derivative products under our net capital rule. Last 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. 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 and modify the rule to provide prudent levels of capital consistent with current derivatives use. At the same time, we are also considering how to incorporate OTC options into the pricing model strategy. This is clearly a more difficult job, as OTC options often lack the same degree of information with respect to pricing and liquidity that are the requisite model inputs.

This difference between listed options and OTC options highlights one problem for many end-users: the lack of choices. The long SEC approval process for listed products has contributed to the success of customized OTC products. The popularity of flex options illustrates that end-users are willing to trade off some degree of customization for the benefits of lesser credit, pricing and settlement risks typically associated with listed products. We need to give directors and senior management real choices so they can reap the advantages of a competitive marketplace.

One way of doing this is by leveling the playing field between exchange-traded and OTC derivatives. Although many factors may drive participants to one market or another, the SEC can do more to encourage greater competition. Currently, new exchange-listed products can take up to one year to make it through SEC review. In contrast, trading committees at firms can approve OTC derivatives in just a few days. I think it's important to diminish the impact of this discrepancy for the benefit of the marketplace and its players.

The SEC's Division of Market Regulation is trying to address this issue by reducing the approval time for new products. The Division is trying to develop generic standards in as many areas as possible, as a means of abolishing the need for tedious product-by-product reviews.

The goal is to set forth general criteria that should be met, so that individual products satisfying these guidelines can be approved upon filing, or maybe even without filing. For instance, the guidelines of options on ADR's and options on country funds are already in place, and we currently have a proposal out for comment on narrow-based index options. I hope that the approval of this proposal will continue be part of a trend that benefits investors and our capital markets.

In addition to addressing capital concerns, we've made inroads with respect to improving the financial disclosure of derivatives. For the first time in modern financial reporting history, you can't look at a balance sheet of an entity with significant derivatives exposure and ascertain the health of that company. Last month, the FASB issued a proposal to require expanded disclosure of derivatives. This proposal would require end-users to distinguish between derivatives held or issued for trading purposes, and those held or issued for risk management or speculation. Although great strides are being made to improve the financial disclosure of derivatives, the bigger issue remains of the lack of harmonized accounting standards internationally.

International Regulatory Efforts

On the international front, regulators have been working together to establish a viable framework for regulation of the global derivatives market. Two months ago, the SEC, the CFTC and the Securities and Investments Board issued a Joint Statement, the first formal international effort to oversee the burgeoning OTC derivatives market. The Joint Statement contains both regulatory, as well as market, goals.

On the regulatory side, the agreement emphasized three objectives. First, we agreed to improve existing arrangements for the exchange of financial and operational information with respect to the major securities and futures firms that each agency regulates. This information exchange occurs as a result of a defined triggered event, such as if a U.S. firm notifies its SRO or primary regulator that its net capital levels are below the minimum required amount. The exchange can also occur if reasonable grounds exist that the financial or operating condition of a firm may be materially affected by a regulated entity.

Second, through the Joint Statement we agreed to establish capital standards that provide incentives for good risk management. All of the agencies are reviewing and modifying their capital standards to create prudent risk-based charges for firms, including the SEC, as I discussed earlier.

Third, the Joint Statement addressed netting arrangements and their impact on capital standards. To control and manage their counterparty credit exposure, market participants need legally enforceable netting arrangements. Unquestionably, credit risk can be just as dangerous as market risk. The Joint Statement establishes 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 broader market goals. These goals include the need 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.

Conclusion

The release of the GAO report tomorrow will stoke the fire of debate regarding the regulation of derivatives. Regardless of how the debate shapes up, it's clear that there are no easy solutions.

End-users, senior management and regulators need to work together to alleviate public concerns regarding the regulation of this $12 trillion market. As more companies and entities include derivatives as part of their risk management portfolio, it's important to demystify their use. Improved disclosure and accounting should go a long way in this regard.

With each new press account of a significant derivatives loss, we in the U.S. face the danger of overreaction with needless, and even potentially harmful, legislation. Congressman Jack Fields, speaking before Congressman Markey's subcommittee last week, underscored this same concern by stating:

> *As the experience of the Eurobond market shows, it is possible for Congressional errors to move financial markets overseas. I, for one, do not want to build markets in London*

and Frankfurt with business that could have been done in the United States.

In the U.S., we are walking a fine line between regulating prudently, and regulating in such a heavy handed manner that we drive business overseas.

Not only do we face the risk of sending business overseas, but companies may decide that their safest course is to ban totally the use of derivatives. This is already happening. Only yesterday, the press reported that Arco has changed its investment strategy to avoid derivative investments after its employee savings plan lost $22 million, or about 5 percent of its value, from such investments. Last month, the press reported that Ameritech stopped its derivatives use pending review by its board of directors in June. A byproduct of the recent corporate losses may well be a reduction in the number of derivatives end-users. The GAO report may have a similar effect.

A knee-jerk reaction in Congress or in corporate boardrooms would be unfortunate. Derivatives are important tools for risk management today. It is important that we enable such products to be used prudently and intelligently. As Congress and regulators around the world debate how to fine tune regulation of this market, I feel confident that we will find a solution that will address investor protection concerns while fulfilling the capital needs of market participants.