S. HRG. 106–922

S. 2697—THE COMMODITY FUTURES MODERNIZATION ACT OF 2000

JOINT HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

AND THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

ON

S. 2697—THE COMMODITY FUTURES MODERNIZATION ACT OF 2000

JUNE 21, 2000

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HEARING ON S. 2697—THE COMMODITY FUTURES MODERNIZATION ACT OF 2000

WEDNESDAY, JUNE 21, 2000

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
AND THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, DC.

The Committees met jointly, pursuant to notice, at 10:07 a.m., in room 106, Dirksen Senate Office Building, Hon. Richard G. Lugar, (Chairman of the Committee on Agriculture, Nutrition and Forestry,) presiding.

Present or submitting a statement: Senators Lugar, Gramm, Bennett, Fitzgerald, Santorum, Grams, Harkin, Sarbanes, Dodd, Kerrey, Conrad, Johnson, and Schumer.

OPENING STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA, CHAIRMAN, COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

The CHAIRMAN. This hearing of the Senate Agriculture Committee and the Senate Banking Committee, held jointly, is open for business. Today I would simply point out the Agriculture Committee and the Banking Committees will hear testimony from members of the President's Working Group in regard to Senate Bill 2697, legislation to provide legal certainty to the over-the-counter derivatives market and to reauthorize and to reform the Commodity Exchange Act. The Commodity Exchange Act expires on September 30 of this year and the Senate Agriculture Committee is charged with reauthorizing this statute.

However, we cannot accomplish this endeavor without the strong assistance and cooperation of members of the Senate Banking Committee. I am very pleased to have the distinguished Chairman of the Senate Banking Committee, Senator Phil Gramm of Texas, joining me as a cosponsor of this important legislation. We look forward to working with the Banking Committee as the legislation proceeds.

Our legislation has been several years in the making. The Senate Agriculture Committee held a two-day roundtable of 19 industry experts in February 1999 to discuss the policies surrounding CFTC reauthorization. Asked to prioritize the issues of importance, most panelists thought legal certainty to be the most pressing issue. Others suggested repeal of the Shad-Johnson Accord and that testimony included Phil Johnson, former CFTC chairman and one-half

of the accord's namesake, and several mentioned regulatory relief for the futures exchanges as an important priority.

Today's hearing representing our committee's fifth public forum on CFTC reauthorization in the last 18-months will hear testimony regarding how all of these issues are addressed in our legislation.

Signed into law in 1974, the modern Commodity Exchange Act requires that futures contracts be traded on a regulated exchange. As a result, a futures contract that is traded off an exchange is illegal and unenforceable in a court of law. When Congress enacted this act, the meaning of the terms "future" and "exchange" were relatively apparent and the over-the-counter derivatives business was in its in infancy.

In the 26-years since the statute's creation, however, the definitions of a swap and a future began to blur. In 1998 the CFTC released its concept release on over-the-counter derivatives, which was perceived by many as a precursor to regulating those instruments as futures. Just the possibility of reaching this conclusion threatened to move significant portions of the business overseas. This led the Treasury Department, the Federal Reserve and the SEC to ask Congress to enact a moratorium on the CFTC's ability to regulate these instruments until after the President's Working Group could complete a study of the issue.

As a result, Congress passed a 6-month moratorium and in November 1999 the President's Working Group completed its unanimous recommendations on derivatives and presented Congress with those findings. This legislation adopts many of the unanimous recommendations of the Working Group's report, including an exclusion for over-the-counter derivatives transacted on an electronic exchange and a clarification of the so-called Treasury Amendment.

Another important recommendation of the Working Group was to authorize futures clearing facilities to clear over-the-counter derivatives in an effort to lessen systemic risk. This bill incorporates that finding.

The second major section of this legislation addresses regulatory relief for the futures market. In February, the CFTC, under the leadership of Chairman Bill Rainer, issued a thoughtful proposal that would provide relief to futures exchanges and their customers. Instead of listing specific requirements for complying with the act, the proposal would require exchanges to meet internationally agreed upon core principles. The CFTC proposal tailors regulation for exchanges based on whether the underlying commodity can be manipulated or whether the users of the exchange are institutional. Our legislation incorporates this framework.

The bill's last major section addresses the Shad-Johnson Jurisdictional Accord, which banned single-stock futures in 1982. The Working Group unanimously agreed that the accord can be repealed if regulatory disparities are resolved between futures and securities. In December Senator Gramm and I sent a letter requesting that the CFTC and the SEC make recommendations on reforming the Shad-Johnson Accord. The SEC and the CFTC responded that although progress had been made, the agencies could not resolve these issues before October of this year.

Disappointment with this answer led Senator Gramm and me to once again ask the agencies to attempt to resolve the problems sur-

rounding lifting the ban. Unfortunately, an agreement within our legislative timeframe was not reached and we have decided to move forward with our legislation.

This legislation would repeal the prohibition on single-stock users and allow these products to trade on either a CFTC-regulated futures exchange or an SEC-regulated securities exchange. Our bill also would provide for joint jurisdiction with each agency maintaining its core authorities over the trading of single-stock users. The legislation would further require that margin levels on these products be harmonized with the options market.

The goal of the legislation is to ensure that the United States remains a global leader in the derivatives marketplace. Already the United States has lost much of its leadership role in the exchange-traded futures markets in Europe and the over-the-counter market may not be far behind. Congress has a good opportunity at this point to reverse this tide by enacting sound legislation this year.

For my own part, I am hopeful that the Agriculture Committee can mark up this legislation prior to the July 4 recess, namely, next week.

The importance of this legislation is reflected by the witnesses assembled before us today and we are grateful for each one of them. Our first panel consists of the head of to President's Working Group, the Honorable Lawrence Summers, Secretary of the United States Department of the Treasury, and the Honorable Alan Greenspan, Chairman of the Federal Reserve System. Our second panel will consist of the Honorable Arthur Levitt, Chairman of the SEC, and the Honorable Bill Rainer, Chairman of the CFTC. We look forward to their insights regarding their agencies' discussions on the Shad-Johnson accord, as well as on all of the other issues.

[The prepared statement of Senator Lugar can be found in the appendix on page 48.]

It is now a privilege to turn to my distinguished colleague, Senator Gramm, for his opening remarks.

OPENING STATEMENT OF HON. PHIL GRAMM, A U.S. SENATOR FROM TEXAS, CHAIRMAN, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

Senator GRAMM. Mr. Chairman, let me first thank you for your leadership on this issue. Let me say for the record that it has been a great privilege to work with you and the excellent staff of the Agriculturee on this bill.

This is an effort that has been undertaken by the Agriculture and Bamking Commmittees to do something that is both important and, obviously, very difficult.

Whenever we work in areas that are cross-jurisdictional in Congress, those differences sometimes become barriers to legislative action, and I want to congratulate you for your leadership in seeing that, that has not happened in this important area.

As I see this bill, we are trying to do three simple things that may not create great excitement among American consumers, but they are very important and affect the well-being, prosperity and financial security of everybody who works, saves, invests and benefits from living and working in the greatest economy in the history of the world.

We want legal certainty for swaps. Most people do not know what swaps are. I am almost incapable of fathoming the volume of swaps in dollar value. When I heard the number as we first started discussing this issue, I was convinced that an error had been made and that someone had mistakenly said trillions instead of billions; I was wrong. This is a huge, critically important markets, and we cannot allow uncertainty about the enforceability of these contracts to stand.

We are all aware that uncertainty occurs because of the off-exchange trading prohibition in the Commodities Exchange Act. If the Commodities Futures Trading Commission deemed these swaps to be futures, that would create this legal uncertainty.

I believe that a similar uncertainty could be created if the SEC deemed them securities and then argued that they were being traded without fulfilling the reporting requirements of the Securities and Exchang4e Commission statute.

Also, it is important for us to note that while two of the most enlightened people who have ever served now head the CFTC and SEC, we have no guarantee that, that leadership is going to remain in the future and regulation doth abhor a vacuum. So, I think it is very important that we have legal certainty as it relates to both CFTC and the SEC

Let me also say that we had hoped, Mr. Chairman, and I know you had hoped, that we could get the CFTC and the SEC to work out an agreement as to how they were going to regulate the new instruments that would be created futures on individual stocks. The SEC and CFTC made a legitimate effort, but they were unable to reach a conclusion as to how to share this regulatory authority.

Ultimately, I have not given up hope that this can be worked out. It is important that it be worked out so that these two important regulatory entities can do what they do best. We need the SEC in all areas to exercise its authority on anti-fraud and insider trading. We need the CFTC doing the things it can do. I think an agreement as to how they can share regulatory responsibility on individual futures could also affect areas where there are still legitimate regulatory concerns concerning swaps.

Second, this bill does provide a new financial instrument that in my opinion is long overdue. There are problems in providing it in that we have to harmonize margins, we have tax differences between options and futures, but none of these problems is insurmountable. We try to deal with them in this bill, and I am sure we will refine the bill as we go along.

And finally, this bill does begin regulatory relief. I am hopeful that by the end of the bill, we can go further. I do not believe that we have done what we should do in providing regulatory relief. The world is very different today than it was in 1934, when we were willing to trade tremendous regulatory burden for transparency. It was the right decision to make at the time, but with modern technology, with the evolution of markets, we have transparency at levels that never existed before.

We have competition from all over the world that would very much like to see this goose that lays the golden egg, these financial markets, roosting in their coop. They are trying to do things to attract it. They are unifying markets. They are reducing regulatory

burden. I believe that we need to do it. No one can convince me that the regulations necessary to protect my parents are the same regulations that are necessary to protect my children in today's financial markets.

We would do well, Mr. Chairman, to remember the Lincoln's adage that to ask a society to live under old and out-moded laws, and I think you could say the same about regulation, is like asking a man to wear the same clothes he wore when he was a boy.

We need a comprehensive review of the regulatory burden in financial markets. We need to challenge every regulation and every law as to benefits versus costs, and when the costs exceed the benefits, we either need to change, overturn or repeal that regulation as law.

Mr. Chairman, you have made an important start here. I want to congratulate you for it. We face a difficult challenge in an election year and the waning days of this Congress, but this is an important issue and, Mr. Chairman, I want to commit to you that I intend to work hard to try to help you be successful.

The CHAIRMAN. Well, thank you very much, Chairman Gramm. I appreciate those comments and your testimony.

Let me try to lay out a format that I hope will be agreeable. I am going to call now upon the distinguished Ranking Member of the Agriculture Committee for an opening statement and upon his appearance, Senator Sarbanes as the Ranking Democratic member on the Banking Committee.

I will ask other members, if I may, to forego opening statements so that we may hear the witnesses. We will have a round of questioning with no more than 5-minutes per Senator because we do have two distinguished panels and we have two committees.

So unless there are strong objections to that format, we will try to proceed on that basis and I will call now upon Senator Harkin for his testimony, his opening statement.

STATEMENT OF THE HON. TOM HARKIN, A U.S. SENATOR FROM IOWA, RANKING MEMBER, COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

Senator HARKIN. Thank you very much, Chairman Lugar and Chairman Gramm. And we welcome Senator Sarbanes and other members of the Committee on Banking, Housing and Urban Affairs.

I appreciate this opportunity to hear the views of the Members of the President's Working Group on Financial Markets concerning the legislation introduced by Senators Lugar, Gramm and Fitzgerald. I especially want to commend you and thank you, Chairman Lugar, for your conscientious work in crafting this important legislation.

I have said before that when it comes to derivatives and everything else that we are dealing with here in terms of complexity, the subject matter of this legislation surely rivals anything that ever comes before our committee, with the possible exception of dairy policy. That may be more convoluted.

The issues are indeed complicated. Their resolution has tremendous ramifications in the markets. The bill that has been introduced clearly reflects the hard work that Chairman Lugar and his

staff has put into it. And, for the most part, it carefully follows the recommendations of the President's Working Group, provides legal certainty for over-the-counter derivatives, ensures regulatory relief for futures exchanges and brings clarity to the Treasury Amendment, finally, in the treatment of certain hybrid instruments, generally modernizes the Commodity Exchange Act to take into account the rapid pace of change in the financial markets and in technology. It seeks to maintain and strengthen the protection of investors in the public interest.

To be sure, there are a number of issues that require further attention. I look forward to working with the Chairman, the Regulatory agencies and other parties to resolve the remaining issues.

As we continue to work on this legislation, we, in essence, have a balancing act to perform. To be sure, there is a real need for legal certainty, for modernizing and reforming regulations. I just Chairman Gramm saying about the old Jeffersonian quote about—in fact, it is engraved in the Jefferson Monument down here, about expecting the adult to wear the clothes of childhood would be the same as expecting the Nation to live by the laws of its ancestors.

But, at the same time, we must ensure that investors are protected and that we do not create disparities in regulation and in competitive positions of the various types of financial markets.

Without a doubt, we now have a truly global financial market. The regulatory climate should not hinder; should enhance the competitive position of U.S. markets and firms. However, when it comes to international competitiveness, there is also a tremendous value to the integrity, safety and soundness of markets, an area where the U.S. has excelled. The cost of transactions is important but over time, money will flow to markets where integrity, safety and soundness are adequately protected. To me, that is the bottom line. Thank you very much, Mr. Chairman.

The CHAIRMAN. Well, thank you very much, Senator Harkin. I commend you again for your thoughtfulness in working with us. Members of the Democratic staff, in a bipartisan way, have been working on this legislation and we appreciate that.

At this point it is my privilege to recognize in the order that I have introduced the witnesses, the distinguished Secretary of the Treasury. He has been a good friend of our committee, coming before us not in each of these five iterations of the CFTC but in many of them, and in his role with the Working Group has already made a contribution, I believe, to American financial security.

Secretary Summers.

Senator DODD. Mr. Chairman, before you do that, I presume that opening statements in which we lavish praise on you and Senator Gramm are appropriate?

The CHAIRMAN. Oh, they would be welcome, published in full. Thank you.

Mr. Summers.

STATEMENT OF THE HON. LAWRENCE SUMMERS, SECRETARY OF THE U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC.

Secretary SUMMERS. Chairman Lugar, Chairman Gramm, Ranking Members Harkin and Sarbanes, members of these Committees,

thank you for giving me the opportunity to testify before you once again on the Commodities Futures Modernization Act.

This is, as your opening statements recognized, an issue that the President's Working Group has grappled with for some time and it is an issue that these committees have been grappling with for some time.

I believe it is a matter of great importance to the future of our financial system and to the future of our economy to move ahead with legislation that provides legal certainty for swaps and OTC derivatives transactions. And I believe that such legislation is now within our grasp, with the unanimous agreement of the President's Working Group and the very substantial consensus that has formed in the central area of legal certainty for OTC derivatives among members of these committees, members of the House of Representatives and the various constituencies.

I believe that if anything, the events of the last year, as we have seen dramatic increases in competition in the financial services area across countries, only go to emphasize the importance of the United States moving to provide legal certainty.

So it is our very great hope that it will be possible to move this year on legislation that, in a suitable way, goes to create legal certainty for OTC derivatives while, at the same time, reducing systemic risk, protecting retail customers, and maintaining U.S. competitiveness.

And it is our belief that the central provisions contained in this bill with respect to OTC derivatives make great progress in achieving these goals and are provisions that we can support as they follow very largely the recommendations of the President's Working Group.

I want to address, however, three remaining issues: the securities question, certain technical questions with respect to regulatory relief for futures exchanges, and Shad-Johnson.

With respect to securities, the bill provides a broad exclusion from the securities laws for swaps, including in particular, swaps based on securities. As a general matter, we do not believe that swaps should be regulated as securities. However, it is important to preserve prohibitions against insider trading, fraud, manipulation, and also to preserve other measures which are demonstrably necessary to protect retail customers.

We are concerned that the provisions as currently drafted could have the unintended consequence of interfering with these vital protections that are now in place for the securities markets. Because the provisions as currently drafted have the potential to impact the underlying securities markets, we believe that it is imperative that they be amended to address these concerns with respect to insider trading, fraud, manipulation, and retail consumer protection.

I would hasten to point out that this is very much consistent with the valid objective of removing unnecessary regulation. I think it is worth emphasizing, however, that there is one important distinction between the securities laws and the commodities laws in that the application of securities laws does not in any context create the kind of legal certainty issues that can arise under the CEA.

The second concern we have is with respect to the regulatory relief section that permits exempt boards of trade. Let me first say that we have looked very carefully at the recommendations that the CFTC has made and while we will be making a formal comment down the road, I can say that we are very much supportive in general of the changes that Chairman Rainer has recommended and believe that they represent a landmark achievement.

And we recognize the importance of competitive parity between the exchange and off-exchange markets, particularly as the status of off-exchange markets is clarified.

Our concern is with certain provisions that, as drafted, could have the perverse consequence of creating a situation where protections that are present with respect to off-exchange trades could actually not be present with respect to transactions that took place on an exchange. These matters are particularly important with respect to the integrity of the Government securities market, as any reduction in the integrity of the Government securities market could lead to higher financing costs for the Treasury and an increased burden on American taxpayers.

Let me turn finally to the question of the Shad-Johnson Accord. We believe that as the Working Group report states, the current prohibition on single-stock futures can and should be repealed if issues about the integrity of the underlying securities market and regulatory arbitrage are resolved. There are a number of concerns, however, that the regulatory agencies consider important that have not been resolved in the legislation. While we have no objection to the introduction of single-stock futures, it is vitally important that the integrity of the underlying markets be preserved and that these instruments not be used as a means to avoid the regulation of the cash market.

But let me be very clear on one point. We believe that this issue should not be allowed to be an impediment to clarifying legal certainty with respect to OTC derivatives. It is our very great hope that it can be resolved in a mutually satisfactory way but we do not believe that it should be allowed to defer OTC derivatives legal certainty, given the overwhelming importance of that issue.

Let me just take this opportunity to comment on an issue that is not part of the bill before you today, and that is the question of the treatment of OTC derivatives in instances of bankruptcy and insolvency.

I would like to take the opportunity to strongly urge the Congress to adopt the President's Working Group's recommendations regarding the treatment of certain financial contracts, including OTC derivatives, in cases of bankruptcy or insolvency. This is a step that could have a meaningful impact on the mitigation of systemic risk.

Mr. Chairman, let me conclude where I began. The achievement of legal certainty and a modern legal and regulatory framework for OTC derivatives is an issue of great importance to our financial system, the competitiveness of our markets and businesses and our economy. With this legislation, it appears that, that goal is within our grasp. I urge this committee to rapidly address the remaining concerns so that we can move forward on much-needed legal certainty in the OTC derivatives market. Thank you.

[The prepared statement of Secretary Summers can be found in the appendix on page 60.]

The CHAIRMAN. Well, thank you very much, Secretary Summers, for your comments and for your endorsement with the caveats that you have given and we will take those seriously.

When I visited with you and with Chairman Greenspan earlier, the Chairman noted a very, very large audience here today for something that is very difficult to understand. I would say the audience is a tribute to the two of you. You are persons that are listened to. You make a difference in our thoughtfulness and I call now upon Chairman Greenspan for his testimony.

STATEMENT OF THE HON. ALAN GREENSPAN, CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, DC.

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I should say chairmen and Ranking Members. This, incidentally, is the first time in all of my years testifying before the Senate that I recall, appearing before a joint committee of this nature, and I must say that considering the nature and presumed complexity and obscurity of this type of legislation, it is a clear testament of how important this issue is to the financial system of the United States, its integrity, and essentially the underlying prosperity which it has been so important in contributing to.

I am especially pleased to be here to present the Federal Reserve Board's views on the Commodity Futures Modernization Act of the Year 2000. My testimony today will be largely identical to the testimony of my colleague Patrick Parkinson delivered on behalf of the Federal Reserve Board last week to the House Subcommittee on Risk Management, Research, and Specialty Crops.

Let me say first that I wish to associate myself with all of the remarks of Secretary Summers and will endeavor not to repeat and go over similar grounds.

The Federal Reserve Board continues to believe that the Commodity Futures Modernization Act of 2000, modernizing the Commodity Exchange Act, is essential. To be sure, the CFTC has recently proposed issuing regulatory exemptions that would reduce legal uncertainty about the enforceability of OTC derivatives transactions and would conform the regulation of futures exchanges to the realities of today's marketplace. These administrative actions by no means obviate the need for legislation, however.

In my remarks today I shall focus on three of the areas that the legislation covers: first, legal certainty for OTC derivatives; second, regulatory relief for U.S. futures exchanges; and third, of course, repeal of Shad-Johnson restrictions on the trading of single-stock futures.

In its November 1999 report, the President's Working Group concluded that OTC derivatives transactions should be subject to the CEA only if necessary to achieve the public policy objectives of the act, deterring market manipulation and protecting investors against fraud and other unfair practices. In the case of financial derivatives transactions involving professional counterparties, the Working Group concluded that regulation was unnecessary for these purposes because financial derivatives generally are not read-

ily susceptible to manipulation and because professional counterparties can protect themselves against fraud and unfair practices. Consequently, the Working Group recommended that financial OTC derivatives transactions between professional counterparties be excluded from coverage of the CEA.

The Federal Reserve Board continues to support the Working Group's conclusions and recommendations. Thus, it supports the exclusions of OTC derivatives from CEA that are included in S. 2697 because with a few exceptions that appear readily resolvable, they are consistent with the Working Group's report.

The Working Group did not make specific recommendations about the regulation of traditional exchange-traded futures markets that use open outcry trading or that allow trading by retail investors. Nevertheless, it called for the CFTC to review the existing regulatory structures, particularly those applicable to financial futures, to ensure that they remain appropriate in light of the objectives of the CEA.

The Federal Reserve Board supports the general approach to regulation that was outlined in the CFTC's recent proposals. For some time the Board has been arguing that the regulatory framework for futures trading, which was designed for the trading of grain futures by the general public, is not appropriate for the trading of financial futures by large institutions. The CFTC's proposals recognize that the current "one-size-fits-all" approach to regulation of futures exchanges is inappropriate, and they generally incorporate sound judgments regarding the degree of regulation needed to achieve the CEA's purposes.

Furthermore, the Board generally supports codification of the CFTC's proposal so as to provide the exchanges with greater certainty regarding future regulation. However, the Treasury Department is concerned that the exempt board of trade provisions might have unintended consequences that could reduce the effectiveness of the existing regulatory framework for the trading of government securities. To facilitate expeditious passage of legislation, it thus may be prudent to limit the codification of the exempt board of trade provisions, at least so that markets currently regulated under the Government Securities Act of 1986 are not affected. In such a scenario, the CFTC could address any unintended consequences for the regulation of government securities by changing the terms of its exemptions.

The Working Group concluded that the current prohibition on single-stock futures, part of the Shad-Johnson Accord, can be repealed if issues about the integrity of the underlyng securities markets and regulatory arbitrage are resolved. The Board believes that S. 2697 provides an appropriate framework for resolving these issues. Such instruments should be allowed to trade on futures exchanges or on securities exchanges with primary regulatory authority assigned to the CFTC or the SEC, respectively. However, the bill recognizes that the SEC should have authority over some aspects of trading of these products on futures exchanges. The scope of the SEC's authority can and should be resolved in negotiations between the CFTC and the SEC. The Congress should continue to urge the two agencies to settle their remaining differences so that investors have the opportunity to trade single-stock futures.

If it would facilitate repeal of the prohibition, the Federal Reserve Board is willing to accept regulatory authority over levels of margins on single-stock futures, as provided in the bill, so long as the Board can delegate that authority to the CFTC, the SEC, or an Intermarket Margin Board consisting of representatives of the three agencies.

The Federal Reserve Board understands that the purpose of such authority would be to preserve the financial integrity of the contract market and thereby prevent systemic risk and to ensure that levels of margins on single-stock futures and options are consistent. The Board would note that for purposes of preserving financial integrity and preventing systemic risk, margin levels on futures and options should be considered consistent, even if they are not identical, if they provide similar levels of protection against defaults by counterparties.

This bill reflects a remarkable consensus on the need for legal certainty for OTC derivatives and regulatory relief for U.S. futures exchanges, issues that have long eluded resolution. These provisions are vitally important to the soundness and competitiveness of our derivatives markets in what is an increasingly integrated and intensely competitive global economy. The Federal Reserve Board trusts that remaining differences regarding single-stock futures and the potential application of the securities laws to OTC derivatives can be resolved quickly and this important piece of legislation can be expedited through this Congress.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Greenspan can be found in the appendix on page 66.]

The CHAIRMAN. Thank you very much, Chairman Greenspan.

We have been joined by Senator Sarbanes, the Ranking Member of the Banking Committee. As the Chair announced earlier, the Ranking Member will be recognized for an opening statement and then we will proceed with a round of questions for the witnesses.

Senator Sarbanes.

STATEMENT OF HON. PAUL S. SARBANES, A U.S. SENATOR FROM MARYLAND, RANKING MEMBER, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

Senator SARBANES. Mr. Chairman, thank you very much.

I will really forego an opening statement except simply to observe that this is a very complex issue and I think we have to proceed with considerable caution and when I have my question period, I will have an opportunity, I think, to pose some questions to the secretary and the Chairman in this regard.

I think we have to work extra hard at trying to get the regulators, who are, after all, the experts in this area upon whom we rely, to see if they can reach a consensus on how they would recommend proceeding with respect to these important questions.

Thank you very much.

The CHAIRMAN. Thank you very much, Senator Sarbanes.

We will have questions now. I will ask that Senators stay within a 5-minute limit. I will ask questions. I will then defer to Chairman Gramm, then to the distinguished Ranking Members—Mr.

Harkin, Sarbanes—and then we will alternate back and forth, republican and Democratic Senators as they have appeared.

Secretary Summers and to some extent Chairman Greenspan has reflected this, in a comment that you make on page 5 of your statement you say, "To be clear, there are provisions of the bill as currently drafted which could have the perverse consequences of creating the situation where protections that are present with respect to off-exchange trades would not be present with respect to transactions that took place on the exchange. These matters have particular importance with respect to the integrity of government securities markets."

Could you amplify that somewhat more? That general point of view of the Treasury, which has been fairly well known in the securities markets for the past week or so, has brought considerable consternation and I would like for you to explore that more in your testimony.

Secretary SUMMERS. Let me just say that I think this is an important but somewhat limited issue in the following sense. We are supportive of the broad program that Chairman Rainer has laid out for deregulation. We are supportive of the pillar of that broad program, which is the idea of exemption for boards of trade.

Our difficulty comes from what is almost a drafting question. In the way the legislation is drafted, it appears to us to allow participants in the exempt boards of trade to avoid the kinds of rules that we have had in place with respect to the Government securities market.

You will recall that there was a major episode a decade ago in which one major firm was involved with an excessive share of a number of different Treasury auctions, subjecting the market to possible manipulation. It is our intent and our desire only that nothing in this legislation preclude the effective enforcement of those provisions with respect to the Government securities markets.

And my understanding is that there has been considerable discussion among the affected parties and I think there is a feeling that it is possible to find language that would address our particular and quite narrowly focused concern, which does not go to the desirability of regulatory relief for futures trading, but only goes to the question of whether or not it would be possible to avoid restrictions that are in place with respect to cornering and the like in the Government securities markets by trading on one of these exempt boards of trade.

The CHAIRMAN. I thank you for that response and I raise the question knowing that there have been considerable efforts on the department's behalf with exchanges with other parties to try to clarify this language. I think Senator Gramm and I share the thought that the greatest hope we have with this legislation is that you and Chairman Greenspan and others are still working with us. This is a work in process because these clarifications are important.

This legislation might last for a long while and it would be difficult to get everybody concentrated again, so we want to do it right. But we appreciate the flexibility that you have already demonstrated and I simply wanted to offer that thought.

Mr. GREENSPAN. Mr. Chairman, if I may, I think it is important to emphasize, as the Secretary has just done, that this is a very narrow technical amendment. It is not questioning the usefulness, the potential usefulness of the new board of trade vehicle. There are many different types of usefulness of that vehicle and we certainly at the Federal Reserve Board see advantages in it.

This is a very narrow issue which we fully subscribe to the Treasury's position on and would like to see some amendment to this particular provision to take care of the Treasury's concerns.

The CHAIRMAN. Well, we look forward to working with you on that language and your proposal would be welcome.

Let me just initiate a subject I suspect that Chairman Gramm will get into further. With regard to legal certainty, we have talked about legal certainty that arose from the so-called Concept Paper on Swaps that the CFTC was responsible for, so we have tried to settle that over there.

Now Chairman Gramm has raised the question, "Well, what about legal certainty with regard to the SEC in this sort of situation?" This seems to have kicked off tremors in various directions.

Let me just say that what is sauce for the goose is sauce for the gander. I share Chairman Gramm's thought that we need to explore really where we are headed with regard to legal certainty. It may have started in one agency but has picked up other problems somewhere else.

Why has this become an element of such consternation? Because obviously it is and your testimony, you mention this, Secretary Summers, as a point of considerable concern.

Secretary SUMMERS. Let me make three points, if I could. I will preface them by saying that having spoken with Chairman Gramm about this, my impression is that there are not fundamental differences that cannot be bridged on this question.

The CHAIRMAN. Well, that is reassuring.

Secretary SUMMERS. Having said that, let me make three points.

First, there is, I think, an asymmetry that we need to be clear about between the securities law issues and the commodities law issues and that is that were these to be subject to the commodities law, there is the possibility that past contracts that have been entered into would be unwound and would not be legally binding. That is why we speak about legal certainty.

There is no parallel feature of the Securities Act that would enable or create any possibility or nexus for past contracts to be unwound and that is why those who have been concerned with the legal certainty question have, until it was recently introduced into the discussion, been focused on the commodities issue and not focussed on the securities issue.

Second, there is nonetheless, in our judgment, a valid objective of responding to some of the kinds of concerns that Chairman Gramm articulated in his earlier statement that we cannot be assured that the prudent forbearance that the SEC has exercised with respect to these issues in recent years will be a permanent state of affairs.

And therefore it may be appropriate for there to be legislative clarification that the intent of the OTC legal certainty is not to shift jurisdiction from one agency to another but, for the reasons

that the Chairman articulated in his testimony, involving the fact that it is professional counterparties who are involved with one another, to provide for a structure in which these transactions would not be subject to extensive regulation. We recognize that as a legitimate and appropriate legislative purpose, even if one that is not perfectly parallel with the commodities case.

The third point though, and the point that I must say, Mr. Chairman, we feel strongly about is that there are a number of types of issues that the securities law provides that are not issues that are covered by the commodities law where we believe it is very important to continue to maintain protection.

To take what may be the easiest example to explain: functionally, through a total return swap, one can do something that is the equivalent of purchasing a share of stock. It would not, in my judgment, be an acceptable outcome for an individual who had benefitted from insider information and who would be legally prohibited from buying a stock or buying an option to be able to engage in a total return swap that was the functional equivalent of buying that stock.

Insider trading, fraud, manipulation, and possibly where there is a demonstrable link, questions of retail protection, it seems to us need to continue to be subject to regulation, not so as to extend some net of regulation to OTC derivatives in a way that they are not now subject to regulation, but only to assure that the basic protections we provide in our cash markets do not become circumvented through this legislation.

And it seems to us that the valid and important objective of clarifying with respect to the future the limits of regulation in this area can be achieved while, at the same time, respecting the very necessary functions the regulation has to perform.

The CHAIRMAN. Thank you very much.

Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

Let me first say, Mr. Secretary and Mr. Chairman, I do not think there are substantive differences as to what we want to do and what you are concerned about.

The best thing you could do about the Government securities is write the language you need and give it to us so that we can put it in the bill and solve that problem. If it creates other problems, obviously we can work them out. But we are in a happy time when government borrowing is diminishing, we do not know how long that is going to last, and we want the Government to be able to borrow when it needs to do so.

Our whole focus to this point on legal certainty has been related to the CFTC and its jurisdiction because it was always believed that if someone was going to claim jurisdiction over swaps, it would be the CFTC. If they asserted jurisdiction, as we all know from that very unhappy period when they were trying to do so, then the potential existed of contracts on swaps being deemed unenforceable because they were traded off the exchange.

But what I am concerned about is the totally different environment where the CFTC has been banned from exercising any jurisdiction, in essence, creating what some regulation innovator would see as a no-man's land, and I would see as freedom but some regu-

lator would see as a no-man's land. An innovative SEC might step in and say, "well, swaps are securities and therefore this swap is illegal because the security was not registered with the SEC, because the security did not meet our disclosure requirements."

We can deal with the anti-fraud concern and the insider trading concern, but we need this dual protection. I agree with the Chairman that we need to work together because in an election year, the only way anything can or should become law is if it is bipartisan and is supported by the administration and Congress.

So if we want to do this, we have to work it out, and I do not see any insurmountable differences. I would like to ask both of your staffs to look at this concern about potential SEC action in the future.

Let me just ask one question that is not related to this, but I ask because it is a simple yes or no answer, but you can elaborate in the time I have left if you want to.

Recently there has been a proposal by the FDIC and a lot of clamoring in the banking industry to raise the FDIC insurance from $100,000 to $200,000 per account. Having lived through the S&L debacle and having seen it first-hand in my state, I have been very reluctant to support this because it represents to me a shifting of risk from the investor to the Government and ultimately to the taxpayer. And I remember that era of brokered deposits, and knowing now that we have Internet banking, this is something that I am concerned about.

I know that you all have looked at it and I just wanted, in a simple, straightforward way, to see what you think about the proposal to raise the insurance limit to $200,000.

Secretary SUMMERS. The Chairman and I have discussed this and I believe we have similar views but I guess we will soon see.

We believe that such an increase would be ill advised and would represent a serious public policy error that would potentially increase systemic risk by eroding market discipline and it is not, in our judgment, necessary in order to protect small savers. So it is not a change that we would support.

Mr. GREENSPAN. I agree with that, Mr. Chairman. Let me just say that there is no question arithmetically that if one looks at the change in consumer prices since 1980 when the original $100,000 ceiling was instituted that for purchasing power parity with the original $100,000 change, it would require a very significant increase.

However, I think that most economists would look back at that $100,000 number and say it was a mistake, probably a bad mistake.

If you go back to the $40,000 change when, in the fall or late part of the year 1974, the ceiling was raised from $20,000 to $40,000, and then ask what is the purchasing power of that as of today, it is just a little more than $100,000. So in that regard, one can very readily see that the problem really gets back to a judgment as to whether the move from $40,000 to $100,000 was the correct move and I think, in retrospect, that the evidence very strongly indicates that it was a mistake and for very much the reasons that Secretary Summers argues.

We are in the process now, driven largely by technology, of very dramatically expanding the domestic and international financial system and it is very important that our market processes are sound and that they are not distorted inordinately by a subsidized structure in the financial system.

And, as a consequence of that, I think it is quite important for all of us to be certain that if we want the really quite extraordinary developments in the financial system, which is what we are discussing today, to effectively assist in what is a change in the world economy and specifically in the United States, where standards of living are rising in a way which we have not seen for a very long period of time, and where we have had an economy which is being supported by a very increasingly sophisticated financial system, we want to be certain that, the market safeguards of that system are not undercut.

And it has been the experience of the Federal Reserve and, I believe, all the remaining banking regulators, and I presume the Treasury Department, as well, that the necessity of having a fully functioning market pricing structure as a means for containing risk is crucial to the system.

We regulators cannot conceivably substitute for the effectiveness of containing risk that counterparty judgments within the market create. It is not even a close call. Anything that we can do to sustain and enhance the viability of counterparty surveillance and the accordingly important strengthening of the financial structure that ensues as a consequence of that, we should endeavor to do.

Increasing that is, doubling—deposit insurance—which essentially would be giving increased subsidies to upper income individuals almost by definition, is, in my judgment, a mistake.

There is a problem, however, which is associated with this issue, which is discussed mainly with regard to the clear difficulties that our community banks are having with regard to maintaining core deposits as a consequence of a very dramatic increase in mutual funds, money market mutual funds, and the capital markets expansion itself. And they understandably are looking for means by which they can get an increased degree of liability support, if I may put it that way.

I certainly sympathize with their concerns and the community banking system is a very important vehicle in this country and I think something which is crucial to the dual banking system, which I, as you have known before, very strongly support.

I do think, however, that other means to solve that particular problem must be found. To employ a major change in the underlying financial structure creating weakness in that underlying financial structure for the purpose of resolving a real problem, but a different type of problem, in my judgment, would be a major policy mistake.

Senator GRAMM. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Gramm.

Senator Harkin.

Senator HARKIN. Thank you, Mr. Chairman.

I would like to focus my remarks and questions on this idea of a level playing field and what this legislation might do to that. Early on, the futures exchanges, as we started this process several

years ago, were concerned that regulatory relief for the swaps would put them at a disadvantage. So the futures exchanges sought relief and that is basically what this bill provides in that regard.

Summarily, Shad-Johnson, if relief is provided for single-stock futures trading, raises questions about the level playing field for other market participants, namely the stock options markets. So again it raises the general question, I think, of the levelness of the regulatory playing field and I think that is an important question for us and overall to the functioning of our U.S. markets.

So I would ask both Chairman Greenspan and Secretary Summers again to once again enlighten us on approaching these questions of a level playing field, whether on Shad-Johnson or in other areas, like swaps versus on-exchange transactions, or electronic versus the traditional exchange markets.

Most of the input that I have had from people in these fields has been along those lines. They are concerned that what we do is going to skew it one way or the other. One will be advantaged and one will be disadvantaged. And I just need some enlightenment on that.

Secretary SUMMERS. We have sought in the President's Working Group recommendations and commenting on this legislation to achieve exactly the principle that you stressed, Senator Harkin, of a level playing field.

The original rationale, as you know, was legal certainty in the OTC area. In my judgment, the suggestion that if one was to provide legal certainty that a level playing field required certain changes in the regulations regarding the exchanges was valid and appropriate. And, as I indicated, the suggestions that Chairman Rainer and his colleagues at the CFTC have put forward seem to us to be very much broadly in the right direction and to be leveling the playing field and subject to the relatively minor concern around the board of trade—minor but crucial, I hasten to say—concern that I highlighted. They seem to us to be broadly appropriate, and I think there is a good case for them being embodied in law and not just in regulations.

So I think we are doing a good job on the level playing field area in that dimension.

I think that if I might, the playing field slopes in many different dimensions in the single-stock futures area and so far, a universally agreed definition of a level playing field has been illusive, precisely because you have the consideration of the cash market, you have the consideration of the single-stock futures market, you have the consideration of the options market, you have the reality that much of this is going to be traded overseas in any event.

So I cannot tell you that a formal agreement has been achieved in the Shad-Johnson area that is universally recognized to represent a level playing field.

What I would suggest to you, however, is that it is, I think, very unfortunate for the financial system if the continuing debate over the precise definition of a level playing field with respect to Shad-Johnson is to preclude us or delay us from achieving legal certainty with respect to OTC derivatives. And any of a variety of possible resolutions of the Shad-Johnson issues, in conjunction with legal

certainty, would be in the Nation's interest relative to no movement forward on legal certainty because of the outstanding Shad-Johnson issue.

That is why I very much would join the Chairman's support for the Congress's encouraging the parties to reach a mutually satisfactory resolution, but in any event——

Senator HARKIN. We have been trying that for a long time.

Secretary SUMMERS. But in any event, not holding legal certainty hostage to the resolution of the Shad-Johnson issue.

Mr. GREENSPAN. Senator, obviously I think the issues you are raising are crucial and they are very simple to state and very difficult to implement. Level playing fields, unfortunately, are too often in the eyes of the beholder and with one tilt in an Einsteinian way, it looks like another tilt if you are coming from another direction.

There are a number of practical issues here which really get down to, for example, margins. Margin requirements in commodity exchanges are markedly lower than they are in general for stocks and here I think there is a legitimate concern about the issue of competitiveness, but it is very important to distinguish between consistent margins and the same level of margins.

Margins basically should be constructed in a manner to protect counterparties against default or nonpayment. And in the commodities business or in the commodities markets, where there is a far more rapid payment of cash when prices move—more exactly, when margins are readjusted very much more quickly in the commodities markets in general and obviously under those conditions, if you have a number of margin calls during the day, which you generally do have on many occasions, and they get paid, that clearly is an issue of having lower margins than would necessarily be the case in securities markets.

And how things are cleared and how things are basically managed can differ quite significantly from one system to another and yet competitively, they can turn out to be very close to being identical.

I think at the end of the day we will only be able to tell whether there are real playing field differences if we, for example, see actual differences in markets as, for example, we have seen a significant shift from exchange-traded derivatives to over-the-counter derivatives and that is suggestive of the fact that clearly there is far more regulatory burden imposed on the exchanges because that is the reason that is often given as to why a goodly part of businesses that could go in either direction would tend to go over the counter.

In that case, you can see what the problems are and you can address them as indeed they are addressed in this bill. But to make ex ante judgments about levels of margins, merely looking at the absolute percentages, is insufficient to make a judgment as to whether they are consistent and indeed competitive.

Senator HARKIN. I see my time is up but it just seems to me that in the futures exchanges, where we have always had to clear our margins on a daily basis, and if you have another one on the option where you do not, then it skews it one way or the other, it seems to me.

Mr. GREENSPAN. And it can be adjusted, however, by having different levels of margins, and that is indeed what does happen.

Senator HARKIN. That may be true, yes. That is what you are suggesting we do, perhaps?

Mr. GREENSPAN. Senator, that is actually what they do. And the question I think we have to make a judgment on, is whether the margins that are imposed by securities firms and/or exchanges and commodity firms and/or exchanges are consistent. And all I am saying is that is not the same statement as they are identical.

Senator HARKIN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Harkin.

Senator SARBANES. Thank you very much, Mr. Chairman.

Chairman Greenspan, in his statement, Secretary Summers observes that the bill provides a broad exclusion from the securities laws for swaps, including, in particular, swaps based on securities. He then goes on to say, "As a general matter, we do not believe that swaps should be regulated as securities. However, it is important to preserve prohibitions against insider trading, fraud, and manipulation and also to preserve other measures which are demonstrably necessary to protect retail customers."

I take it you agree with that position?

Mr. GREENSPAN. I do indeed, Senator.

Senator SARBANES. I would like to ask both of you, what are the risks of implementing the language as currently drafted in the legislation?

Secretary SUMMERS. I think this is an issue that is easily remediable but nonetheless needs to be remedied because I think the language as currently drafted would at least raise the prospect of substantial evasion of existing predications with respect to insider trading, with respect to fraud and with respect to market manipulation and thereby could undermine the integrity not just of the OTC derivatives markets but also of the underlying markets with which they are arbitraged.

So as drafted, we would have very great concerns about the language.

We do believe that the objective which we believe was sought in drafting the legislation, which is to clarify that the objective here is deregulation rather than a shift of regulatory jurisdiction, is an objective that can be achieved without compromising these critical objectives.

As we suggested earlier, I think we can all work together on language that would achieve that objective, but the bill as we understand it in its current form would, without amendment, potentially pose a real risk to the integrity of financial markets.

Senator SARBANES. Mr. Chairman, do you want to add to that?

Mr. GREENSPAN. I would only like to say, Senator, that this problem of the definition of swaps and securities I think is getting us tangled up in verbose language.

I had a chance to read the legal definition of a security that is in the 1933 and 1934 acts and I will tell you I appreciate the difficulties that lawyers have in this world. I defy anybody to read it and come up with a reasonably good judgment of what it says.

Swaps are even worse. Not only are they difficult to define but after you have defined them, you will find that everyone has a different view of what constitutes a swap.

I think that what is important here is for the Congress to look at the fundamental structures of the markets with which we are dealing, try to make a judgment of what the appropriate regulatory structure is, one, as Senator Harkin has said, that creates a level playing field and also, as he talked in terms of the integrity, safety and soundness of markets, which I think is a very important issue with respect to the competitiveness of the United States in the world markets.

I think that we should do that in trying to make judgments of what is appropriate and try to eliminate this particular detailed discussion of whether something is a swap or it is a security, and therefore if it is a security, something should happen; if it is a swap, something should happen. I think this is a very difficult type of issue to get involved in and I am afraid we are getting tangled up in language, and the issues are very difficult as they are. If we are going to have those types of problems, we are not going to get an effective resolution of this issue.

Senator SARBANES. That would suggest, in view of your previous answer, that we should focus on insider trading, fraud, manipulation, and make sure that any possibility for those practices to take place is precluded under the regulatory scheme. Would that be correct?

Mr. GREENSPAN. Exactly, Senator.

Senator SARBANES. I think the President's Working Group on Financial Markets was an important initiative and I know the legislation contains a number of the recommendations that came forward from the group, which represented a consensus judgment by the group, unanimous, as I understand it.

My question is, what do you see as the prospects on those remaining outstanding issues on which a consensus has not yet been reached within the Working Group but which are resolved one way or another in the legislation? If we continue to press the Working Group to continue its discussions and consultations, would they be able to come up with a consensus position?

You have been involved in that byplay back and forth. What are the prospects?

Secretary SUMMERS. With the exception of Shad-Johnson and possibly with the exception of the securities question that we have been discussing, I believe the Working Group has essentially agreed on all important aspects of this legislation and that you could have full agreement on this legislation.

I believe with respect to the securities question, I would not want to be in the position of speaking for the SEC and the CFTC but I think you have seen the Chairman and I have essentially identical positions with respect to that question.

With respect to Shad-Johnson, I would not want to confidently predict that there would be a conclusion. It is an issue, unlike some of the other issues, that is a very crucial issue for two members of the Working Group—the SEC and the CFTC. And my understanding is that they have worked in very good faith to try to reach common ground and have not yet succeeded.

I suspect that I speak for the Chairman in saying that we are very much prepared to do anything we can do to facilitate reaching an agreement and I thought that the Chairman's offer in his testimony that the Federal Reserve would be prepared in a variety of different formulations to become involved with margin requirements for single-stock futures, if that would be facilitating of an agreement, was a constructive and valuable step. But I do not think I can honestly predict for you with great optimism that an agreement will be reached in the near future.

I would repeat the judgment that the Chairman and I both expressed earlier that any of a variety of possible resolutions that pave the way to the passage of this legislation would be better than no resolution and a continuing risk to legal certainty.

Mr. GREENSPAN. I might just add that in a certain sense, if Shad-Johnson is not revised in a manner which is to the interests of the American regulatory structure, it is going to get revised for us because there is just little question in my judgment that we are not all that far away from single-stock futures on U.S. stocks trading in other countries. And if we do not resolve this issue, Shad-Johnson will get resolved but not in a manner which I think would be desirable for any of us.

I have worked with many SEC and CFTC Chairmen. I have never had the pleasure of, as some of you have mentioned, working with two committed individuals of the types we now have in those chairmanships. If they are having trouble with this issue, it is because it is a very difficult issue to meld very complex regulatory structures.

My concern is that if they cannot get it resolved and we cannot get it in a legislative vehicle, that the issue is going to get resolved for us but not in the way that we would like it to happen.

Senator SARBANES. Mr. Chairman, I just make the observation that not too long ago we were working in the Banking Committee on an important piece of legislation and they said, "Well, you will never get the Treasury and the Federal Reserve to reach an understanding on that issue." And in the last analysis, they did reach an understanding, which was an important breakthrough in moving that legislation forward. So, if we keep working at this, maybe we can get it resolved. Thank you very much.

The CHAIRMAN. I thank you, Senator Sarbanes, for your question and likewise both of you for your response. I will just editorialize before I recognize my colleague that we really are at the heart of the matter.

Without being chauvinistic, we are Americans talking about United States markets and it is inconceivable that however learned people are in various agencies, they cannot come to some agreement.

Now, we are attempting to facilitate that, I think calmly. Senator Gramm and I are not hysterical about the issue but we are determined. This is very, very important for our country and both of you have testified amply to that this morning in a very technical way.

STATEMENT OF HON. PETER G. FITZGERALD, A U.S. SENATOR FROM ILLINOIS

Senator FITZGERALD. Thank you very much, Mr. Chairman, and I thank both of you for testifying today.

Mr. Greenspan, I appreciate your comments about Shad-Johnson and I wholeheartedly agree with you. If we do not repeal Shad-Johnson, we are going to be confronted with foreign nations that are offering individual stock futures on our American companies. I think if we can put a man on the moon, we can repeal Shad-Johnson and get an agreement between the SEC and the CFTC.

Mr. Greenspan, maybe you could elaborate on how the regulators cooperate in the banking industry. We actually have many more regulators in the banking industry than just the two we are talking about here—the CFTC and the SEC. You have state banking examiners examining state banks. Across the street from a state bank in Main Street, U.S.A. there is typically a national bank that is regulated by the OCC. Both of them, if they offer FDIC insurance, are subject to the regulation of the FDIC. If they have holding companies, they are monitored by you.

Now, I notice in Mr. Levitt's testimony, reading ahead, that he objects to provisions in this bill that require the SEC, before taking enforcement action, to ask permission of the CFTC. Now I do not know if any of the banking regulators, such as the FDIC or the OCC, would have to ask permission of other regulators if they wanted to take an enforcement action. However, I do think that they commonly notify other regulators as a matter of course. I do not get the impression that, that slows down the enforcement very much.

Would you care to comment on that?

Mr. GREENSPAN. Yes, Senator, I think that is quite correct. One of the vehicles that we have is an organization of all of the regulators in which we work together in a fairly formal systematic way. And over the years we have recognized the various problems that inevitably arise when you have a dual banking system, multiple regulators, and the system will either work or it will not work. And if it will not work, what is going to happen inevitably is clearly the Congress is going to decide to run a single regulator bill through both houses of the Congress and it will get passed very readily and the issue will be resolved, frankly, to the detriment of the system.

I think that to have different regulators effectively competing in many respects and jointly endeavoring to come up with new ideas as to how to integrate regulation into the market structure to get maximum efficiency has been a very effective tool of the American regulatory system.

And I think that, despite the fact that there are inevitable significant disagreements, and there are unquestionably unbelievable delays in getting agreements on certain issues, nonetheless, at the end of the day, it works.

Senator FITZGERALD. What is your super regulatory body called?

Mr. GREENSPAN. It is the Federal—my problem is I have so many acronyms in my head, I cannot unleash——

Senator FITZGERALD. Did that come in after the FIRREA legislation or after the S&L?

Mr. MATTINGLY. Senator, it is Federal Financial Institutions Examination Council and it goes back to about 1978.

Senator FITZGERALD. 1978, okay.

Mr. GREENSPAN. That is Virgil Mattingly, our General Counsel, and you can see why we find him a significant source of insight.

Senator FITZGERALD. Well, maybe the SEC and the CFTC could just jointly put some task force together with members from both regulatory bodies just so that they have ongoing communication. That would seem to make sense to me.

Well, in the interest of time, I will yield to some of my colleagues for further questions.I thank you for that positive encouragement about how it works in banking.

[The prepared statement of Senator Fitzgerald can be found in the appendix on page 50.]

The CHAIRMAN. Thank you very much, Senator Fitzgerald.

Senator Kerrey.

STATEMENT OF HON. J. ROBERT KERREY, A U.S. SENATOR FROM NEBRASKA

Senator KERREY. Mr. Chairman, first of all, I want to thank both you and Chairman Gramm for holding this hearing and I hope it leads to a mark-up of the bill.

It seems to me the challenge of the Committee, and I put this to both Secretary Summers and Chairman Greenspan, the challenge for both of the Committees is that we have to separate out those concerns raised by individuals who simply do not want to compete because, at the end of the day, this is about money and that is why this room is full of people; this is about money and it is about jurisdiction that controls who gets to regulate.

And you can see it in the pattern of lawsuits over the last 25-years, initiated in the early 1970s. In fact, there has been a pattern. It starts with a lawsuit filed in 1975, resolved in favor of the CFTC. That led to Shad-Johnson. Another lawsuit filed in 1992. That leads to another piece of legislation.

And then the most recent lawsuit filed after the SEC objected under 2(A)(1)(b) of the CEA, to an instrument that was being traded on the Chicago futures in a Dow-Jones utility and transportation index. So they have objected. That is in court and still not settled. So I do not know; maybe there is a case to be made that we should wait until this lawsuit gets settled.

I would not, Mr. Chairman, because I think we have to separate, and I put it to you gentleman, it seems to me we have to separate out those concerns that are just about money and control from those legitimate concerns having to do with what has been raised on several occasions—risk to investors, and so forth, including, by the way, one additional risk that was raised after the stock market crash. The SEC claimed that one of the reasons the stock market crashed in 1987 and perhaps again as a consequence of concerns for making a case so they could continue to control, that it was stock market indexes that caused the crash. Trading and speculating in stock market indexes, the SEC argued in 1987, caused that crash.

So I would ask you, it seems to me that we did that. This committee heard concerns that there was regulatory uncertainty hav-

ing to do with swaps and other instruments. They were being offered, derivative instruments, offered OTC. And we listened. We had hearings on it and we listened to all the concerns. It was a hot issue and I think the Agriculture Committee did a pretty good job of sorting out and coming up with a recommendation that would create regulatory certainty, as well as the other piece of our legislation that codifies a lot of the regulatory changes that CFTC has put in place.

And it seems to me that we ought to do the final thing with these stock indexes, the stock future instruments that are being proposed. They were proposed first by the CFTC, challenged now in court. A, we have to decide, do we want to wait for the court to make a decision, or do we sort of take it into our own hands and try to decide on our own? And I would argue the latter, frankly, that we ought to try to separate out where we think a case is being made in a legitimate way and where a case is being made in an illegitimate way that these instruments should not be allowed to be traded.

So I would just ask—seek your advice on this. Do you think we should wait for the court to make a decision or do you think we should, in our best judgment, now that the two chairmen have gotten us together, and some have argued that it is about money on our side, as well, that we are concerned about losing jurisdiction between the Agriculture and Banking Committee. I have personally never seen any evidence of that but maybe it exists, in fact, back in the old days.

Would you recommend that this committee take action to try to resolve this most recent conflict that is being raised over individual stock futures?

Secretary SUMMERS. I basically share the impulses behind your question, Senator Kerrey. I do not think that waiting until particular lawsuits have wended their way through the courts is a good way to make public policy in this area. I think case-by-case litigation is probably, as a general proposition, a poor way to make public policy in this type of issue, first. And second, as both the Chairman and I have stressed, we think that it is important that the legal certainty issue not be delayed with respect to the Shad-Johnson issue.

So, as I have said several times now and just to make the point clear, any of a number of possible approaches that this bill could take to Shad-Johnson in conjunction with legal certainty would be better than this bill not moving forward because of Shad-Johnson.

To be sure, one of those approaches would be simply not treating the Shad-Johnson issue within this legislation and leaving it to other legislation. Another possibility would be a number of different possible resolutions of this issue. But I think the point on which, if I can speak for him, also, the Chairman and I feel most strongly is that it would be terribly unfortunate if the debate over Shad-Johnson were just to continue in a way that delayed resolution of the Shad-Johnson question——

Senator KERREY. I must respectfully disagree. We resolved the one conflict and this is basically the CFTC and the SEC fighting this thing out. That is what is going on here. We are concerned about risk about insider trading, fraud, manipulation, leverage and

risk and potential temptation of stock manipulation. We will factor all that into consideration but at the end of the day, the SEC and the CFTC, they are going to go into court and fight this thing out.

So we figured the one out, the derivative issue, the Ag Committee figured that out, but now we have another issue that is being raised on behalf of the SEC filing a lawsuit against the CFTC. So on behalf of the Ag Committee and the CFTC, I have to say that we have to do both of them together.

And if we were able to sort out and figure out what is best for the consumer and what is best for financial risk, it seems to me we ought to be able to do it on this issue, as well, and we should before we move a piece of legislation.

Secretary SUMMERS. It would certainly be very desirable to achieve. It would certainly be very desirable——

Senator KERREY. All the issues having to do with insider trading, fraud, manipulation, leverage and risk and the issues that Senator Gramm raised about having differentials in margins, the insider trader issues that are different between the SEC and the CFTC, all these, the tax problems, we have high enough IQs to figure this out and it seem to me that we ought to figure it out and we ought to include it in the legislation.

Mr. GREENSPAN. Senator, I think, without commenting on the particular suit that you are raising, in this type of issue it is a mistake to leave it to the courts to decide. The reason basically is that what we are dealing with at this point is a changing economy and the changing necessary regulatory structure that would be required with it.

The courts, of necessity, are required to reach judgment on existing statute and on existing precedent and indeed, what they are effectively measuring is the judgments that the Congress made in an earlier period. And it strikes me that it is terribly important when dealing with an issue such as this in a rapidly evolving financial industry that the Congress should address it from scratch in a sense, to take a look at it de novo and make judgments of an appropriate type to determine what is the structure because there is no way that the courts can do that; nor should they. They are there for a fundamentally different purpose and to abandon a decision of this nature to legal issues, in my judgment, is a mistake.

Senator KERREY. I agree. Or to wait until we have put another man on the moon. The last time we put a man on the moon was before Shad-Johnson. That is the other thing we could do. We could wait for another man to arrive on the moon and do this thing.

I agree with you, Mr. Chairman. It seems to me that we have enough information, we have good enough judgment that we ought to be able to figure this thing out and we should. And I personally would object to saying well, we will do the derivatives, along with codifying the changes that the CFTC has made in the regulation, but we are not going to resolve the single-stock issue. We can do that, as well, and I think we should.

The CHAIRMAN. Thank you very much, Senator Kerrey.

Let me just comment that Senator Kerrey deserves congratulations, along with our colleague, Senator Roberts. They were major proponents of a crop insurance risk management bill that this committee worked on—tremendously complex issues. And with our

House components, the president signed the legislation yesterday. It was not well heralded but it should have been because it is a genuine achievement in a year in which not much legislation is occurring that is complex and that crosses a lot of boundaries.

So when the Senator from Nebraska speaks, we all listen and he is energized this morning. I am grateful that, that is so.

STATEMENT OF ROBERT F. BENNETT, A U.S. SENATOR FROM UTAH

Senator BENNETT. Thank you, Mr. Chairman.

I do not have the technical background to challenge any of the discussion that has gone on. Let me ask a potentially stupid but hopefully big picture question.

This situation is fraught with turf battles between the CFTC and the SEC and we are going to hear from both of those gentlemen in just a moment and each one will be very articulate and eloquent in defending his own agency and his own position.

Do either of you have a big picture kind of sense as to where this regulation, the center of gravity ought to come down? Is this really an SEC kind of thing or is this really a CFTC kind of thing? And should most of it be on one or most of it be on the other?

Mr. GREENSPAN. I have just gotten laryngitis.

[Laughter.]

Senator BENNETT. It is either a really dumb question or a very good one.

Secretary SUMMERS. It is a very good question.

Mr. GREENSPAN. Senator, I may just say whenever you make those remarks I zip up my pockets and run.

Secretary SUMMERS. It is a very good question and I am seeking to draw on what I have learned from watching Chairman Greenspan over the years to formulate a suitably vague, a suitably extensively analytical but yet nondecisive answer.

Senator SARBANES. In other words, you just got laryngitis, as well.

Secretary SUMMERS. I think the difficulty involves, and the two chairmen will speak in a much more learned way to this than I can, that what you are discussing is a future, which naturally falls within the ambit of the CFTC. And the issues that are of concern having to do with insider trading, having to do certain kinds of market integrity, are issues that go to—having to do with consumer protection—are issues that really go to core SEC, what have been core SEC concerns for many years. I think it is that dichotomy between where the instrument would tend to naturally fall and where the concerns would tend to naturally fall that creates the difficulty.

But it does, to borrow on the kind of analogies that have been used before, it does strike me that a Nation that has been as successful as ours has been at mediating conflicts in a range of settings internationally ought to be able to find a way of mediating the tensions that exist here. But I suspect the right answers will not be ones that are heavily tilted to either end of the spectrum.

Senator BENNETT. Does that mean then that both regulators will stay fully involved and anybody who is in this business is going to be wondering from day to day which regulator is going to come

down hardest? Don't we want some degree of—you talk about certainty; we talk about predictability—don't we want some degree of unity here where you deal with one set of regulations and you know that another regulator will not come in and penalize you for having done that? Or can we really split the baby and say they both still are in the arena?

Secretary SUMMERS. At least in my judgment, Senator Bennett, any formula that resolves this will be just as the agreement that Chairman Greenspan and I reached with respect to the operating subsidiary issue was one of very substantial complexity and I think in some ways in that complexity lay its strength. It was neither fully satisfactory nor fully unsatisfactory to either of us and it enabled us both to feel that our core concerns had been expressed.

I do think that a resolution which subjects these transactions to the full weight of regulation of both agencies would, for the reasons you suggest, be an unfortunate outcome. I also think a resolution which subjects them to whichever was the least regulation of the two agencies might well apply substantial pressure in a negative direction.

So I think some more complex formula involving certain kinds of joint rule-making might prove to be most effective. But I think this is a question that is really better addressed to the two agencies.

Senator BENNETT. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Bennett.

Senator Schumer.

STATEMENT OF HON. CHARLES E. SCHUMER, A U.S. SENATOR FROM NEW YORK

Senator SCHUMER. Well, thank you, Mr. Chairmen. I very much appreciate this hearing on an issue that I am very interested in. It obviously affects New York in a great many ways.

I think this proposal has potentially profound and dramatic effects on our securities and future markets and I am disappointed, frankly, with the bill's treatment of Shad-Johnson and giving the CFTC sole jurisdiction over single-stock futures. I am not opposed to single-stock futures. If we do not allow U.S. exchanges to offer them we could see them offered in London or Tokyo. And in general, when the market comes up with new types of products, my general view is let it rip. But the regulatory framework has to be right and the President's Working Group recommended that Shad-Johnson be repealed and that single-stock futures be allowed to be traded if and only if could achieve regulatory parity for futures and their underlying equities.

There is no way with the SEC regulating one and the CFTC regulating the other that we will have regulatory parity. They are different types of regulators. They have a different regulatory structure. And this bill creates regulatory disparity by substantially different regulatory frameworks for regulation.

We know why we are doing this. It is always a turf war, as you gentlemen are very familiar with from last year's discussion of financial futures, and neither side wants to give us their turf. And, at the end, we come up with this topsy-turvy gyro gearless solution that satisfies turf needs and does not make any sense from a regulatory point of view.

The SEC has always been charged with protecting investors and providing full and fair disclosure of corporate market information and preventing fraud and manipulation. The CFTC regulates commercial and professional hedging and speculation in an institutional framework. CFTC cannot regulate insider trading. Margin requirements are different. I hate to see investors shopping as to which instrument to use or to buy for that reason. So neither regulation nor the lack of it should pick winners and losers among products or exchanges and fair competition should.

Simply put, to me, the SEC cannot fulfill its legal obligation to oversee the securities markets if single-stock futures, which will likely have significant effect on the securities markets, are solely regulated by the CFTC.

And today I am going to introduce legislation that would provide for joint jurisdiction of single-stock futures by the SEC and the CFTC, that will create a fair framework for trading these products while minimizing the regulatory burden on the exchanges. Specifically, it would only apply to core securities laws—anti-fraud sales practice requirements and harmonize margin levels to single-stock futures. I think this represents a fair compromise and I would like to work with the Chairmen of both committees, as well as you gentlemen, to deal with that issue.

So having stated my views somewhat strongly, because I feel strongly about the issue, I would like to ask both Chairman Greenspan and Secretary Summers your view of whether the present bill provides a fair and even regulatory framework, specifically whether the President's Working Group recommendations, that we repeal it only if we could achieve regulatory parity for futures and their underlying equities—that is the President's own Working Group statement—is met in the bill that was introduced by my two men I greatly respect and work with, Chairman Gramm and Chairman Lugar.

So since it is the President's Working Group, I will call on Secretary Summers first.

Secretary SUMMERS. Thank you. As I have said a number of times, Senator Schumer, we think there are a range of possible outcomes that would be consistent with this bill advancing the national interest, first.

Second, if I might just refer back to the analogy that you had used of the issues that the Chairman and I worked through successfully last year, I think it is tempting for those looking on to these issues to see only concerns of turf, but in that issue there were real concerns on both sides having to do with spreading safety nets on the Fed side, having to do with business choice on our side. And similarly with respect to this issue, I think we are not fair to our colleagues in the two agencies if we do not recognize that there were real issues of principle that the agencies feel strongly about that go totally behind and are outside of any question of turf that are involved in these issues.

I have not studied as fully as I could the provisions, the precise provisions of the bill as currently written but I think I speak for all of us in saying that we would be more comfortable with a resolution in which the SEC could feel that its core interests with respect to insider trading and consumer protection were addressed,

and my understanding is that they do not have that feeling about this legislation as it currently stands.

On the other hand, I would hasten to stress I think it is very important that there be an outcome here and that this issue be resolved in a mutually satisfactory way and I would not want to see us adopt a posture of handing the ability to hold this issue hostage to multiple different parties and therefore delaying forward movement on the OTC certainty portion.

Mr. GREENSPAN. I agree with what the Secretary said and I think that as you said, Senator, time is crucial here because if the two agencies cannot work it out or if the Congress cannot work it out, foreigners will. It is not a question of whether or not there will be single-stock futures out there it is only: traded where? And unless this issue is resolved, if it is continuously debated endlessly, the issue will get resolved but not to our advantage.

I think that Secretary Summers and I have recognized that the Chairmen of the SEC and the CFTC are far more knowledgeable than either of us on the technical details and the ramifications and the unintended consequences of various different types of stipulated regulatory structures and there are certain types of issues which that type of expertise is just not substitutable by just people's off-the-top-of-their head opinions which, in my case, it would be the case.

So I sort of am looking to the two of them to get the issue resolved because if they resolve it, in my judgment, I will feel comfortable that there are no latent secondary consequences that the less informed on these issues would endeavor to miss.

Senator SCHUMER. I would just say, and I could not agree with you more, that they ought to be resolved between the two agencies. I will not ask you this but it seems to me that the legislation introduced does not really attempt to resolve those issues but rather, just goes to one side.

And I would ask both of you to use your good offices. You do not have the expertise that the two agencies have. On the other hand, you are both very bright people who understand financial markets and who do not have, because maybe not all of this is turf—clearly it is not—but it not that none of it is turf. And we can argue about whether it is 50/50, 80/20, 20/80, but I think you are both going to be needed to come up with some kind of compromise that allows us to go forward with single-stock futures which is, as I said, something I support, but do it and avoid regulatory arbitrage.

I mean for instance, just on margins, almost inevitably you will have people go to the less regulated market if you have such disparities between the regulation between the one and the other, and that may be a desirable outcome, it may not, but we ought not to come to that conclusion by default.

We need your help. Both of you are reluctant to mix in but my guess is we are not going to come up with a proposal that both sides can work unless some folks like yourselves mix in. I am gloomy about passage for this year unless some outside forces help work out a compromise.

The CHAIRMAN. Let me just thank you very much, Senator, and commend you for that request of our two witnesses. I would share

that desire for counsel and likewise, your own counsel with regard to this.

I am not so gloomy. I think we need to proceed and before introducing Senator Grams, I just want to mention I just received word that the House Subcommittee on Risk Management and Specialty, perhaps stimulated by our hearing this morning, has announced a mark-up for tomorrow on their bill.

Senator GRAMM. They have obviously solved all these problems.

The CHAIRMAN. The full committee, Agriculture Committee of the House, will mark up their work next Tuesday, so that offers at least some incentive for us to move ahead.

Senator Grams.

STATEMENT OF HON. ROD GRAMS, A U.S. SENATOR FROM MINNESOTA

Senator GRAMS. Thank you very much, Mr. Chairman.

Gentlemen, thank you for being here, of course. Just a couple of brief questions. I know you have been at the panel for a long time this morning.

Chairman Greenspan, you indicated in your statement that over-the-counter derivatives could remain free from regulation so long as the transaction involved professional counterparties. How do you define professional counterparties?

Mr. GREENSPAN. There are legal definitions of that but essentially, somebody who is in the business of dealing with securities and has sufficient net worth to segregate them from what we would want to determine are retail customers whose basic activities do not give them the level of knowledge which people who are in the business have. By professional, we mean somebody who is a professional securities or commodities person.

Of necessity, it is clearly a somewhat arbitrary legal definition, but indeed in legislation and in regulation, we do make those distinctions and we make them in a very rigid form. We do not always get it exact, but for 98-percent of the problem that we would have with respect to making that division, I suspect we are successful.

Senator GRAMS. And second, we go to some length to try to assure that stock futures have a similar type of oversight as do the stock options. This gets to the heart of the Shad-Johnson debate. When we turn our attention to legal certainty for OTC derivatives, do we need to have the same level of oversight for the over-the-counter swaps involving stocks or other forms of equity?

Mr. GREENSPAN. Well, I think that if the basic purpose is to have a sound market, the first judgment you have to make is does the market structure itself have in it the means for stabilization? In other words, as the issue I raised before, it has been our experience that having effective counterparties in transactions, people who understand the financial statement of the people with whom they are dealing is unquestionably the most important aspect which keeps risk at a minimum level in the system.

Regulation can only substitute at the margins and oversee, so far as over-the-counter securities are concerned, in a professional manner very broad notions of guarding against systemic risk. When you get to questions of retail markets, it is a wholly different issue and

I think there is general agreement amongst all of us about how that should be handled.

Our major concern is to make certain that these very effective over-the-counter derivatives markets which have been so important to the financial development of this country can operate in the most effective manner. In our judgment, that is best maintained with a minimum of regulation, largely because any regulation which is imposed, which would undercut counterparty surveillance does, far more damage than good.

Senator GRAMS. Thank you, Mr. Chairman.

Secretary Summers, we have heard this morning about losing derivative markets to Europe. If this bill passed, the legal environment for derivatives?

Secretary SUMMERS. I should give you a detailed answer, a more detailed answer than I can give you right now to that question in writing. But the core of that answer would be that the failure to pass this bill would create a situation where derivatives contracts entered into in the United States would be subject to more risk, to be sure, an extremely remote risk, but more risk of being arbitrarily unwound because of a regulatory action than in Europe.

And in a world where it is easy to change the location at which contracts are booked, that residual uncertainty could become an important feature of competitive disadvantage. So the core of the answer would be greater residual uncertainty associated with OTC swaps in the United States.

Senator GRAMS. Maybe if you can provide a more detailed written answer.

And just one final quick question. In your concern, Secretary Summers, about exempting swaps from securities laws, are you suggesting that all swaps be given the same treatment, regardless of the underlying financial instrument involved?

Secretary SUMMERS. No. I am suggesting that one craft the set of provisions that are necessary to assure that—I think the most prominent examples of this will be those that involve individual equities—that one craft the minimal set of provisions that assures that there will not be circumvention of the existing regulatory protections with respect to the factors that we have enumerated—insider trading, manipulation, fraud, and protection of retail investors.

There are also, and this is not something we have commented on so far, there are also certain questions having to do with the technical definition of a swap in portions of this legislation which on some readings could lead it to be called a swap if a transaction took place in what we today regard as ordinary financial instruments on an off-exchange basis and would therefore nullify the regulation that would apply to that. That is a concern that we believe should also be addressed in clarifying the language that is contained in these provisions.

It is not my impression that, that is anyone's intent and so we do not believe that should be a difficult clarification to accomplish.

Senator GRAMS. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Grams.

Secretary Summers, Chairman Greenspan, we are grateful to you for your testimony, for your forthcoming responses to our ques-

tions, and we look forward especially in these next few days to working with you and your associates very carefully. Thank you very much for coming.

The Chair would like to call now the Chairman of the SEC, Mr. Arthur Levitt, and the Chairman of the CFTC, Mr. William Rainer.

We are grateful that the two Chairmen are with us. We appreciate your being here to hear the testimony that has preceded yours, but we look especially to your thoughts this morning and I would like to call upon now Chairman Levitt for his testimony.

STATEMENT OF HON. ARTHUR LEVITT, CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC.

Mr. LEVITT. Chairman Gramm, Chairman Lugar and members of the Committees, thank you for the opportunity to address the Committees concerning Senate Bill 2697. This bill would provide important legal certainty for over-the-counter derivatives and would lift the ban on single-stock futures. As you know, the Commission fully supports both of these objectives. In other important respects, however, I believe that the bill presents a number of serious risks to the investing public and to our securities markets.

As we consider the implications of the bill, it serves us well to remember both the wisdom embodied in our securities regulatory framework and the extraordinary prosperity it has fostered. Its wisdom, I think, is simple—a recognition that protecting investors is not just the right thing to do, but the smart thing to do; that it is investor confidence that ultimately fuels competition, that vibrant markets rest on a foundation of integrity. I strongly believe that the unequivocal commitment to protecting investors made by your predecessors and mine has been critical to the success our securities markets have enjoyed for more than half a century.

The bill before you, consistent with the Working Group's recommendations, goes a long way towards providing greater legal certainty for over-the-counter derivatives by excluding certain products from the Commodity Exchange Act.

The bill, however, goes well beyond this objective. Indeed, it would place all swap agreements beyond the reach of the securities laws. In doing so, it might result in a wholesale removal of SEC oversight of a wide array of securities products.

For example, one could potentially avoid long-established investor and market integrity protections applicable to equity securities by merely documenting an equity transaction as a "swap." In my judgment, the risk of this regulatory approach is simply unacceptable for America's investors. Moreover, I think there is no apparent public policy justification for this far-reaching provision.

The bill also lifts the ban on single-stock futures contained in the Shad-Johnson Accord. I certainly have no interest in justifying the historical origins of that ban here today. I have made clear my view that market demand—and not regulatory fiat—should determine the availability of investment vehicles. But I would hope we face squarely the fact that single-stock futures are an economic substitute for the underlying security. We should not ignore the fabric of protections that retail securities investors rely upon and the confidence that these protections engender.

Some may dismiss this concern as a guise for protection of turf. I assure you, the questions surrounding how best to ensure that regulatory disparities do not erode investor confidence are profoundly serious and substantive to me.

Chairman Rainer and I, and our staffs, have spent a great deal of time exploring how single-stock futures might trade. Although we did not reach agreement on all aspects of a regulatory framework, we did agree that we should jointly regulate these products. Building upon that recognition, my staff has crafted a plan under which these products could trade. In my judgment, an enduring regulatory framework must have the following elements.

First, single-stock futures are undeniably a substitute for stocks and stock options. Thus, the framework must recognize the legitimate interests of both the SEC and the CFTC in regulating these products.

Second, the framework must encourage fair competition among markets by, for example, including mechanisms to harmonize the regulatory requirements across the securities and commodities markets, particularly those related to margin. Competitive market forces, rather than government regulation, should pick winners and losers.

Legislation also should facilitate the listing of the same single-stock futures on multiple exchanges. This avoids any one market having an exclusive franchise by forcing all markets to compete for investors' business. The history of our securities markets makes it crystal clear that vibrant competition between markets is the surest path to protecting investors as well as the guardian of our global competitive edge.

Third, the framework must acknowledge that single-stock futures will be retail products. While extremely complex derivative products might not attract retail customers, a simple future on a share of a blue chip stock is the type of product that is sure to do so. Investor protection is therefore essential, as is clear and direct SEC authority over market participants that trade single-stock futures.

The alternative is neither workable nor wise. Consider for a moment a corporate insider who learns that his company is about to receive an unsolicited bid to be taken over. The insider buys a substantial amount of single-stock futures on a futures exchange and earns huge profits on the transaction, which he plans to send to an off-shore bank.

Without direct authority over the futures exchange and direct access to the information we need to detect insider trading, the SEC might learn of the futures purchase by the insider either late or never. Even if the SEC was notified of the suspicious futures transactions, our enforcement staff would be forced, under the current bill, to seek CFTC permission to proceed. Needless to say, enforcement is an area where dispatch is essential and delays are fatal to the cause of securing relief.

Or consider the disparity in obligations that would apply to a broker authorized to sell both stocks and single-stock futures to clients. If he sells the future, he need provide no more than a one-time risk disclosure document that, in effect, tells customers that futures are risky. If he sells the stock, on the other hand, he takes on a duty to tailor the recommendation to the specific needs of the

client. One does not have to be a cynic to spot his incentive to sell the product offering less protection and it is hardly apocalyptic to recognize the danger. Should the protections given a brokerage client really depend on which product the broker chooses to sell? Ignoring these obvious questions today, it seems to me, will almost certainly result in disillusioned investors tomorrow.

Finally, the framework must avoid any harm to existing capital markets. In lifting the ban on single-stock futures and reopening jurisdictional issues, legislative changes should not take away existing SEC authority over financial products. The Shad-Johnson Accord clarified the SEC's jurisdiction over securities options, and that jurisdiction should not be diminished in any way. Nor should legislation eliminate the SEC's existing role in evaluating products such as stock indices.

Achieving these four principles will leave U.S. markets for these products better positioned to compete against their foreign counterparts. As markets around the world compete for customers and capital, one overriding principle will serve as our competitive advantage: the quality of our markets. Unfortunately, as written, the bill ultimately does not vindicate those principles.

I look forward to providing additional technical assistance to help you reach the right answer for our markets. Thank you.

[The prepared statement of Mr. Levitt can be found in the appendix on page 73.]

The CHAIRMAN. Thank you very much, Mr. Chairman.

Chairman Rainer.

STATEMENT OF THE HON. WILLIAM RAINER, CHAIRMAN OF THE COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC.

Mr. RAINER. Thank you, Chairman Lugar, Chairman Gramm, Senator Sarbanes, Senator Harkin and Members of the Committee. I am pleased to appear before you this morning and thank you for inviting me as I represent the CFTC.

The Commission commends your efforts to modernize the Commodity Exchange Act and to provide legal certainty for over-the-counter derivatives, remove impediments to innovation, and to reduce systemic risk. This bill responds to the President's Working Group's request for urgent legislative action on its recommendations so that the U.S. may retain its leadership in these rapidly developing markets.

The Commission welcomes your proposal to enhance legal certainty for over-the-counter derivatives by excluding from the CEA certain bilateral transactions enter into on a principal-to-principal basis by eligible parties.

The market for derivatives has expanded dramatically over the past two decades as financial institutions rely increasingly on these transactions to manage interest rate and foreign exchange risk.

The Commission has reservations, however, about the bill's exclusion of OTC energy derivatives from the CEA and I would like to take a moment to expand on that if I may. On this point the bill diverges from the recommendations of the President's Working Group, which limited the proposed exclusion to financial derivatives. The Commission believes the distinction drawn by the Work-

ing Group between financial and nonfinancial transactions was a sound one and respectfully urges the Committees to give weight to that distinction.

Most dealers in the financial swaps market are either institutions subject to supervision by bank regulatory agencies or affiliates of broker-dealers regulated by the SEC or affiliates of FCMs subject to CFTC oversight. The same cannot be said of trading in energy derivatives. The decision to extend the exclusion in 2697 to energy derivatives would leave these OTC products in a regulatory gap neither directly regulated as financial products nor indirectly regulated by an agency with jurisdiction over commercial participants in the energy market.

The Working Group's recommended exclusion from CEA for financial contracts focussed on the facts that such contracts are not susceptible to manipulation and do not serve a price discovery function. The consensus exists within the markets and among financial regulators that trading in financial OTC derivatives is not susceptible to manipulation. That case has not been made with energy products.

The unanimous recommendation for an exclusion for financial products resulted from months of deliberation by Federal financial regulators. No comparable coordination has occurred between the CFTC and any of the other Federal entities and programs with jurisdiction over cash markets for energy. An exclusion for trading in energy contracts may create incentives for existing exchanges to convert to restricted, institutional markets or, more likely, may lead large traders to migrate to unregulated markets. Either event would threaten the important price discovery role played by regulated energy futures. A step of this magnitude should be preceded by public discussion.

The CFTC therefore believes that there is insufficient evidence to support the bill's exclusion of energy products. Regulatory relief is more appropriately provided through the commission's exemptive authority. We have a substantial history of responsiveness in this area.

For example, the commission's staff has issued two no-action letters within the past 6-months to electronic trading platforms, the sponsors of which include several of the largest participants in the energy markets. And, as the Committees are aware, bilateral OTC energy trading between commercials, dealing with each other on a principle-to-principle basis, has been exempted from all but anti-manipulation provisions of the CEA since 1993.

As the discussion over the treatment of energy commodities progresses, the Commission will be pleased to continue working with the Chairmen and members of these committees to find an acceptable resolution of this issue.

The Commission supports 2697's exclusion for electronic trading facilities for OTC financial derivatives which will promote an environment in which innovative systems can flourish without undue regulatory constraints. Electronic trading systems have the potential to foster efficiency and transparency and such systems should be permitted to develop unburdened by an anticipatory regulatory structure.

The bill also permits clearing of OTC derivatives and authorizes a mechanism for the CFTC to regulate facilities that clear OTC derivative contracts. Again the President's Working Group specifically recommended removing the legal obstacles to the development of appropriately regulated clearing systems to reduce systemic risk, and we support this recommendation with the following reservation. The bill would allow securities clearinghouses to clear a broader range of contracts than futures clearinghouses. Futures clearinghouses would have to register in a dual capacity—as futures and as securities clearinghouses—to clear the same mix of contracts available to securities clearinghouses holding a single registration. By declining to grant futures clearinghouses equal opportunity to compete, the bill may put the Government in the position of determining winners and losers. We recombined that the Committees avoid placing futures clearinghouses at a competitive disadvantage.

The Commission supports the bill's revision of the Treasury Amendment to make clear our jurisdiction over transactions entered into between retail customs and unregulated entities, including so-called bucket shops. We have long sought legal clarity in this area in order to protect fully the public from foreign currency fraud.

Earlier this month the Commission approved for publication in the FEDERAL REGISTER its comprehensive regulatory reform package which alters fundamentally the Commission's regulation of futures and options markets. This bill attempts to codify much of the Commission's regulatory reform proposal and we welcome your support of the Commission's initiative.

The CFTC staff is undertaking a comparative analysis of our proposed framework as released on June 8 and the relevant provisions of this legislation and we would be pleased to submit the results of that review to the Committees in the very near future.

S. 2697 addresses the issue of equity futures contracts and reflects efforts to develop a plan to amend the Shad-Johnson Accord. The Working Group recommended, as we have heard a lot today, that the CFTC and SEC work together to determine how the accord should be amended. We agree in principle that equity futures should be available to the marketplace. Agency staffs have agreed on many specific areas related to lifting the ban, such as harmonizing margin requirements, restricting dual trading, testing for sales and supervisory personnel, establishment of uniform listing standards for single-stock futures, among others, such as notice registration for exchanges and intermediaries. We acknowledge, however, a fundamental disagreement concerning the appropriate legislative approach.

The CFTC has sought to avoid creating a framework that potentially could result in overregulation of markets and intermediaries and therefore have advocated identifying those core principles from each regulatory regime necessary to ensure an appropriate level of oversight for trading these products. While the agencies agreed that duplicative regulation must be avoided, the CFTC staff expressed concern that an "umbrella" approach, meaning the application of the panoply of both securities and commodities regulations to these products, could result in overburdensome regulation. The

SEC staff insists that defining equity futures products as securities is essential to its regulatory functions. This fundamental difference in approach has led an impasse.

With respect to this bill, S. 2697, we, the CFTC, have no objection to the Shad-Johnson provisions that bear on regulatory issues related to the CFTC's oversight of single-stock futures.

Again we appreciate the opportunity to present our views and I will be happy to answer questions. Thank you.

[The prepared statement of Mr. Rainer can be found in the appendix on page 85.]

The CHAIRMAN. Well, thank you very much, Mr. Chairman.

Let me just begin this round of questions. We will have a 5-minute limit again for Senators to raise questions with witnesses.

Chairman Levitt, you mention in your testimony that the Commission staff of the SEC has prepared a discussion draft that incorporates the legislative goals that you have enumerated in your testimony with regard to the single-stock option situation, Shad-Johnson Accord repeal.

Unfortunately, given the pendency of this bill, as well as bills in the House, the CFTC has not apparently had a chance to review or comment on our draft in detail.

Chairman Rainer indicates, not really to respond to that, that there appear to be some fundamental disagreements with regard to regulation or overregulation, a panoply or umbrella, as he discussed it.

I am just simply curious really, to both of you. It is obvious this is important legislation. The Committee has been intent upon moving toward conclusions and we appreciate the discussions that you have held and cited the meeting of May 23 with Chairman Gramm and myself in which you indicated you have been making headway but, as you stated last winter, I guess, it was going to be this winter before you could arrive at it.

This is not meant, I am certain, to be disrespectful to the Committee or to show a casual approach but it should have been apparent to the two of you that we are intent upon passing a bill.

Now, is the strategy you have in mind to stop the bill? Is really your intent simply to indicate to members of the Congress that whatever we have is unacceptable and therefore you are prepared to continue at your own pace, sort of in your own sweet time, to work it out—November, December, January, whenever you get around to it?

In other words, I really cannot understand, given the gravity of this situation of markets in the United States and the intent of this committee to try to work with the Banking Committee, why the two of you and your commissions are not equally arduous, have not set a priority to get on with it and to come to agreement.

Now obviously you have not, so we have. Now, you objected to that and indicated that you are still passing papers back and forth, but you are not listening to each other apparently or have no intent upon reaching an agreement.

I just ask simply why not?

Mr. LEVITT. Mr. Chairman, I respect the effort you have put into this, and I certainly share your feeling about the importance of aspects of this bill. I think Chairman Rainer and I have worked very

hard, as have our staffs, on dealing with an issue that most of the members of the Committee agree is terribly complex issues that we have not, of our own volition, raised, issues that we have inherited, that courts have dealt with and others have argued about for a quarter of a century.

I think that had we a greater amount of time, we could move further toward a solution. But when, as you full well know, you have the political imperatives of the process that we have, together with constituent pressures, together with agency habits and traditions, that makes it difficult. But I honestly believe that, because of the nature of the relationship of the Chairs that sit before you, we certainly do not wish to frustrate the Congress or the bill. But I would say to you in fairness that I regard one portion of the bill with respect to certainty—legal certainty for derivatives—as being absolutely critical to the national interest.

I place a lower priority with respect to Shad-Johnson, even though I firmly support giving up the prohibitions of Shad-Johnson. But one is a matter, in my judgment, of great national economic necessity; the other simply is not.

The CHAIRMAN. Chairman Rainer, do you have a comment?

Mr. RAINER. Yes, thank you.

First of all, from the CFTC's perspective, your bill is one that we do not object to. We think that our interests, the CFTC's interests, are adequately covered by the bill.

However, as you know, I have said several times that we recognize the legitimate interest of the SEC and we think that it would be very important for the structure that goes out the door to be one that both agencies can support.

I guess that the longer story is that we have two wonderful industries—the securities industry, with its exchanges and associations, and the futures industry—and they have grown up in different regulatory environments. It would be one solution for the CFTC to walk away from what I consider its obligation and say well, just let the SEC do it. What happens there is you have opened up a potentially large—we've used the word unlevel playing field several times, but a large unlevel playing field because the apparatus, the costly regulatory apparatus in place with the futures industry is not organized to meet SEC issues.

And I felt that the CFTC should do everything it could to analyze those issues that would be duplicative, that we they already do a good job meeting regulatory tests, and we simply have not had time using the SEC approach to make sure that any recommendation that the CFTC endorses for these committees is the recommendation that is the least cost approach and does not attach unnecessary costs.

Now, if there are burdens that are necessary, so be it. That is just the way it is. But we have not been able to find that answer yet.

The CHAIRMAN. Well, I thank both of you for those thoughtful responses.

Chairman Levitt, I just disagree with you profoundly that there is one aspect of this bill that has national interest. That dismays me with regard to the thought about the markets in this country, the importance of this. That is, I think, a very narrow view, but

it is an interesting one, one that you hold strongly, but it leads me to believe that we have a problem here.

Now, there is going to be a presidential election, a congressional election. We may have a different president—probably will have, given the fact that there are two different candidates running, no incumbent. A lot of new cabinet people, a whole new working group, maybe some new appointees to regulatory commissions, a lot of new Senators, maybe new chairman.

Senator GRAMM. Now wait a minute. You have gone too far.

The CHAIRMAN. Phil will still remain.

But it is not a cavalier approach that somehow this can all be settled out in the fullness of time, given the agencies' ability, their staffs to get together, to shuffle the papers and think through the issues. I am confounded. This has gone on for months.

We have had five different hearings here. We have had all sorts of sessions about emergencies. So we finally come to a meting and everybody is asking Chairman Greenspan, Secretary Summers, to get the two of you together and somehow mediate this dispute, to give their judgment. Chairman Greenspan gets laryngitis at the thought of trying to mediate what seems to have been an impossible predictable in Washington to do. So this committee is going to try.

Now, you can try to stop us if you want to but by and large, I think the public interest is on our side, and I hope you get that picture.

Mr. LEVITT. Mr. Chairman, I have absolutely no interest in trying to frustrate the will of the Senate, but I think we must recognize that what is happening in this bill with respect to Shad-Johnson is taking basically an institutional product, a product that has been used by professional investors, and turning it into a retail vehicle.

At this level of the market, with the amount of leverage in our system today, for me to look away from the responsibility of protecting a different segment of the market than is now available to these products would be irresponsible, in my judgment. That is not a political judgment; that is a conviction based upon my years in the securities industry and my firm belief that there are limits to regulation, but that protection of that individual investor is fundamental to the glorious success of our equities markets.

And I must raise my hand if I feel that those interest are being jeopardized. I believe that a Shad-Johnson bill allowing investors to buy a leveraged product of that kind without the basic protections that the securities laws have provided through the years is just unacceptable.

The CHAIRMAN. Thank you.

Senator Gramm.

Senator GRAMM. Mr. Chairman, thank you. I will be brief.

I want to thank each of you for appearing today and for your hard work as we try to put the bill together.

Obviously, it is easy for us to ask "why can't these two guys get together and work this thing out?" Now, I can work out anything with anybody, but there are people who think they have trouble working things out with me, so I have some understanding of your problem.

I also understand that you are representing institutions that have long and proud histories, and I also understand the basic fact that part of what your staff is doing, and they are going to be there long after you are gone, is protecting their jurisdiction, their turf, and their jobs. I never understood jurisdiction till I became the Chairman of a committee. I now understand it very, very well. And if I forgot it, my staff would remind me.

The only point I want to make is that this is an important bill. It is easy for each of us to go down the list of items in the bill and identify what we think is the most important. I have my own set of priorities, but my guess is that if we are going to have any success, we have to move forward with the overall thrust of the bill.

Now, the only plea I would make—a plea instead of a question—is that as we continue to move forward and work on this, both of you and your two agencies continue to work together. I would like to ask each of you formally to give us your review of the bill and your proposed changes so that we can go ahead and do the things we can agree on.

And, as we go through the legislative process, if you would continue to pray over this thing, in an effort to work it out. Also please think about the possibility of a mandate, similar to the provision that we are now talking about in terms of harmonization of margins, where we give the Federal Reserve, working with your two agencies, the ability to set regulations that harmonize margins. It may very well be at some point that the best we can do—unless our prayers are answered and you work these things out in advance—is to establish a mechanism for you to work them out.

My fear is double regulation. I think that in some areas, the SEC has expertise that ought to dominate in this market. I do believe futures on individual stocks are predominantly equities. What I would like to be able to do is work out a way of sharing jurisdiction in those areas where you have a legitimate legislated interest.

So continue to work it out. Think about ways we might actually set a mandate in place that it be worked out in the future if, all else failing, that is the only way we can do it. It is not a terribly good way to legislate, but it is often better than not legislating when there are other major items.

So Mr. Chairman, I want to thank you and the heads of our two agencies.

The CHAIRMAN. Thank you, Senator Gramm.

Senator Sarbanes.

Senator SARBANES. Mr. Chairman, I want to sort of sound some words of caution here. First of all, it seems to me that the quickest way to get to a solution may be to continue to push hard on the track of the two chairmen before us working out between themselves a resolution of this matter. That essentially is what, I think, both Chairman Greenspan and Secretary Summers suggested.

I am mindful of what Senator Gramm said at the outset, that at this point in the legislative process, it is going to be very hard to move legislation through if it does not rise to the level of consensus.

Now, I happen to think that this perspective that is being imposed on this difference that it is just a turf war, a fight over jurisdiction, misses the mark. I frankly do not attribute that basic moti-

vation to either of these two chairmen that are now before us and they obviously have a public interest to serve that transcends any jurisdictional or tough turf considerations. I do not think this can be viewed as well, we have met the CFTC interests but we have not met the SEC interests, or vice versa. The question is have we met the public interest? And the premise, I think, with which most of us are approaching it is that if the two agencies can reach an agreement, that it is highly likely that the public interest has been met, although obviously we will review that. We do not, in the end, give away that judgment. But that significantly heightens the ability to conclude that the public interest has been met and I think investor protections are very important.

It is all fine to talk about this thing prospectively but if we do something that, in the end, results in eroding or undermining the investor protections that have been at the heart of making the U.S. security market so attractive and the leaders worldwide, we have done real harm and real damage.

Now, it seems to me it ought to be possible to move ahead on this issue without jeopardizing that important accomplishment, which has sustained not only our markets but, I think, been a tremendous boost to the functioning of our economy. And if we are now going to move off on a legislative path and, in effect, bring to a halt or sort of undercut the effort for the agencies to see if they cannot reach an understanding, and I gather they have made some progress; is that correct? I gather from what you have both said you have made progress from when you started out wrestling with this issue. Am I correct in that assertion?

Mr. RAINER. That is a very safe assertion.

Senator SARBANES. All right.

So I think that sometimes haste makes waste. Obviously if there is an agreement amongst the president's committee, all four of the people who appeared this morning, in the light of such an agreement, it ought to be possible to move pretty quickly here in the Congress.

Now, how quickly you can move in the Congress if you do not have that agreement is another question, which I think we need to be very mindful of because the issues that are at stake here, in my perception, at least, are not simply some kind of turf fight and we ought to sort of dismiss one or the other or come down hard on both. They are issues that go to very important national and public interests and I think we need to be mindful of that every step of the way.

Thank you very much.

The CHAIRMAN. Well, thank you very much, Senator Sarbanes. Let me just comment that I agree with you. Very clearly the work of the Agriculture Committee and the Banking Committee, working with the SEC and CFTC, has been to not only protect the integrity of the markets, to offer protection to individuals and groups, but really to recognize that the integrity of those markets is our strength.

Now the predicament I think we all have to weigh, and this is a judgment call, is that during the last year I visited the New York Stock Exchange; I have visited the NASDAQ people. I have been in the Chicago markets. There are a lot of changes going on in

these markets. People who are making a living out there, tens of thousands of employees, face erosion of their job potential.

We face competition in the world. There are other people who are doing all sorts of things. In the course of our hearings we had an electronic demonstration and transacted a trade right in front of us on his computer on a European market and demonstrated really, I suppose, the benefit of our regulation one way or another was irrelevant to all of that.

So, on the one hand, we are trying to think through how do we offer these assurances and more of them and, at the same time, how do we retain at least the ability to see what is going on in the world and retain the strength and the vitality of our markets that have all these protections, and that is a difficult thing to do.

Now one item that is unacceptable, it seems to me, is to do nothing. If we do that, the markets will run their course without regard to what the Congress has to say and there will be winners and losers but I think the American people will be the losers.

Now, the case has been made that the American people will lose if somehow protections are taken away from them and that is a very good point and it is an important one. But again and again we have tried to come, I think, to a conclusion, are the kinds of persons who are involved in the markets, as Alan Greenspan said today, the countervailing market forces that eyeball each other, that bring transparency, that bring competition—he made the point that regulators are never a match for all of the competing forces in markets, that at best, they sort of have a safety net after really those who are competitors have had a go at it.

So that is the problem.

Senator SARBANES. Well, the problem is if we are going to continue this dialogue, and I am quite happy to do it, the problem to some extent is a process problem.

Now, we have this President's Working Group. I gather that the President's Working Group limited the proposed exclusion to financial derivatives. The bill before us now is going to exclude energy derivatives, if I am correct.

Is that right, Mr. Rainer, as you read the bill?

Mr. RAINER. Yes.

Senator SARBANES. You are opposed to that. Is that right? I mean that is counter to the recommendation of the Working Group.

Mr. RAINER. My position is that the case has just not been made that is a good idea.

Senator SARBANES. Yes. And therefore it ought not to be done at this point.

Now, we discussed earlier the swaps question and it is very clear from that conversation that significant changes have to be made in the swaps provision. Everyone acceded to that.

Now, I understand that the CFTC put a proposal out on a regulatory framework for future markets and clearing organizations on June 8. Is that correct?

Mr. RAINER. Yes.

Senator SARBANES. Now, that proposal is contained in this legislation; is that right?

Mr. RAINER. In large part, yes.

Senator SARBANES. Well, it may be all right; it may not be all right. But you are putting the proposal out to have a comment period. Is that right?

Mr. RAINER. Yes.

Senator SARBANES. And further hearings.

Mr. RAINER. Yes.

Senator SARBANES. The premise of those further hearings and the comment proposal is the possibility that you would revise the proposal, correct?

Mr. RAINER. Yes.

Senator SARBANES. That is why you do that.

Mr. RAINER. Yes.

Senator SARBANES. And you approach it with an open mind so that people who make comments have confidence that they will be considered on the substance and a judgment will be made.

Now, where does that leave you if this legislation passes that contains the proposal you have submitted but does not reflect the comment period and the hearings that subsequently take place in shaping that? I mean it renders it all sort of meaningless in a sense. Plus it then puts you in a straightjacket in the future if you want to revise the regulations because they have been statutorily codified. So at that point if you wanted to make changes, you would have to come back to the Congress and get a legislative change.

Now, that is only to underscore the haste makes waste observation that I made earlier. But in the end, we are going to come back. I appreciate that the industry wants to move and I am not unsympathetic to that, but it ought to be possible to do that and, at the same time, assure ourselves that these very important protections for investors that have been at the heart, in my judgment, at the heart of these very successful markets are not lost. And to the extent we short-circuit this process and make it less likely we are going to reach this kind of consensus, I think the problem becomes more difficult, not less difficult.

The CHAIRMAN. The Senator makes a good point. I would just simply say that everybody is struggling, given the amount of time that Senators, regulators, what have you have to give to these particular issues, to get our focus. We have comment from everybody today on language that might be incorporated. That is a serious proposal because we are in the process of heading toward a markup in which something is going to happen in the Committee, and then we hope to proceed.

You have not had an opportunity to get into this round, Senator Schumer. Would you like to raise questions or make a comment?

Senator SCHUMER. Thank you, Senator Lugar. Yes, I have some questions relating to my concern.

I guess the first one is to Chairman Levitt. Do you worry about the effect that introducing single-stock futures will have on the underlying equity markets if it SEC has no jurisdiction over the product? What will be the worst case scenario?

Mr. LEVITT. I do worry about it. I worry a great deal about it. I think there are some irrationalities in this process, and I guess the very fact that we have two regulators regulating similar segments of the market provides us with some irrationalities to begin with. Then when you suggest in a bill that has something as na-

tionally urgent as giving legal certainty to swaps and you combine that with creating a new vehicle for investors, you have to ask yourself what is the importance of that new vehicle? That new vehicle, has dramatic importance to the liquidity of our markets with respect to institutions that are used to trading highly leveraged products. You are now opening that market to the retail investor, who does not have the slightest idea about this.

We found in surveys, in terms of an understanding of the risks of investment products, many do not understand the risks of products even that have been with us for many years. We are now opening up this new product, which essentially is leverage on leverage.

Is this in the national interest to begin with? If you say it is, if this new product is offering America's investors something they can get no place else, which I absolutely categorically deny, then you have to say are we giving them the same protection that they would have when they buy IBM or General Motors or any other equity?

And remember at what point in the market cycle we ask ourselves this question. Is this the time to introduce yet an even more highly leveraged product into a market which, in my judgment, has an abundance of leverage today?

Senator SCHUMER. Well, there is a little ad that I would like to submit for the record from—I do not know who they are—Lynd Waldock. It says, "There are lots of reasons you should consider online stock index futures trading"—this may be an example of what you are talking about for a broader-based product. "At Lynd Waldock you get"—it says, "Stocks are great for the long term but for short-term trading, try stock index futures. At Lynd Waldock you get a of bang for your commission buck. One stock's index future commission is equivalent to trading 2,000 to 3,000 shares of stock at $30 a stock at about half a penny a share."

And that will be nothing compared to what happens unless we have, as you say, a level regulatory field here. Does the Gramm–Lugar proposal, as written, provide that field? To me it certainly does not.

Mr. LEVITT. I think it leaves the retail investor with an absence of basic protections. I think, working closely with the Committees and with the CFTC, it is possible for us to develop such protections for investors from the things that I fear the most.

Senator SCHUMER. What is the rationale for an option being governed by the SEC and a future being governed by the CFTC of an equity? Options are now governed by the SEC.

Mr. LEVITT. They should not be. You know, I hate to criticize a bill that has been sponsored by someone whom I admire so much, but, with respect to the kind of regulation that we are talking about, Senator, it is split regulation, and that is very different from shared regulation.

Senator SCHUMER. Correct.

Mr. LEVITT. And if collectively we could work toward shared regulation, you would remove many of my feelings about this bill, which are not motivated by any issue other than the protection of investors.

Senator SCHUMER. Would you agree with that, Chairman Rainer? Right now the bill has—Chairman Levitt put it right, at least as far as I can tell—split regulation. Would you agree that a shared regulation formula could work and would you be willing to entertain that?

Mr. RAINER. Senator Schumer, I have been from the outset in favor of both joint regulation and the ability for both markets—the equity markets and the futures markets—to be able to offer these products.

Senator SCHUMER. The issue is not who offers the products. The issue is who regulates the product. Would you be willing to say that shared regulation is, if not the best, certainly a good way to go, particularly if it can break the deadlock that we seem to have?

Mr. RAINER. Senator, I think that when I say joint regulation, I mean shared regulation, but I am not 100-percent sure I know what you mean by a definition of shared versus split.

My position, which I have mentioned, is that this bill, strictly from the perspective of the CFTC, adequately addresses our concerns. Having said that, I have said in other venues that I recognize the important and significant interests of the SEC and that I believe that any final regulatory structure should be one that both agencies can support.

Senator SCHUMER. OK. So you would, if Chairman Levitt has in his delicate way—he is more delicate than I am—indicated he has real troubles with the bill as proposed, as much as he respects Chairman Lugar and Chairman Gramm, and let's put that in the record 10 times, would you then encourage that we wait and see if we can come up with something that you and he can agree upon, provided it can be done in a relatively short frame of time? Would you agree that we should not move forward with this bill, which seems to me is not a shared regulatory regime at all?

Mr. RAINER. Senator, I am going to withhold that for right now. Let me get back to you on that.

Senator SCHUMER. If you could submit that in writing.

And one other thing I would ask that you submit in writing is your comments, your objections to the—you cannot know much about it yet but the proposal that I have put in today, which I think is a shared regulatory regime that I think would be fair and sort of go right down the middle, as opposed to this bill, which I think does not really do that.

Mr. RAINER. Of course, Senator.

Senator SCHUMER. Great.

Thank you, Mr. Chairman.

The CHAIRMAN. Well, thank you very much, Senator Schumer. I appreciate your comments likewise and will examine your legislation, too. It is an important factor. I just ask from you, as well as everyone else, some appreciation of the time frame that we all have to work in because the Senate session will be over soon, the window of opportunity to deal with this at all, whatever its merit.

So my hope, and this is obvious in terms of trying to press this issue on this morning, is that there is a certain season for these things to happen. If we are not able to, why, we will all have a lot of time, but there will be maybe different players, a different situation and different position of our markets, for better or for worse.

So it seems to me that this is an appropriate time for us to focus as our two committees have attempted to do so this morning and will be doing so in a concerted way in the next few days.

Senator SCHUMER. The only thing I would say, Mr. Chairman, I agree with you but I would rather—if there were a choice and I agree with you I hope there is not a choice or a division, but I would rather do it right than do it quickly. I am sure you would agree with that.

The CHAIRMAN. I do agree with that and we are most hopeful we can do both, always.

Senator SCHUMER. Great.

The CHAIRMAN. We thank both of the Chairmen for your patience. It has been an extended hearing this morning but you have been with us all the way and we appreciate that. Thank you.

The hearing is adjourned.

[Whereupon, at 1:03 p.m., the joint Committee hearing was adjourned.]

APPENDIX

JUNE 21, 2000

Chairman Dick Lugar, U.S. Senator for Indiana

Opening Statement

Date: 6/21/00

Ag/Banking Hearing on CEA

Today the Senate Agriculture and Banking Committees will hear testimony from members of the President's Working Group regarding S. 2697, legislation to provide legal certainty to the over-the-counter derivatives market and to reauthorize and reform the Commodity Exchange Act. The Commodity Exchange Act expires on September 30th of this year, and the Senate Agriculture Committee is charged with reauthorizing this statute. However, we cannot accomplish this endeavor without the assistance and cooperation of the members of the Senate Banking Committee. I am pleased to have the distinguished chairman of the Senate Banking Committee, Senator Gramm, joining me as a cosponsor of this important legislation, and we look forward to working with his Committee as this legislation proceeds.

This legislation has been several years in the making. The Senate Agriculture Committee held a two day roundtable of 19 industry experts in February of 1999 to discuss the policies surrounding CFTC reauthorization. Asked to prioritize the issues of importance, most panelists thought legal certainty to be the most pressing issue; others suggested repeal of the Shad-Johnson Accord, including Phil Johnson, former CFTC Chairman and one half of the Accord's namesake; and several mentioned regulatory relief for the futures exchanges. Today's hearing, representing our Committee's fifth public forum on CFTC reauthorization in the last 18 months, will hear testimony regarding how all of these issues are addressed in our legislation.

Signed into law in 1974, the modern Commodity Exchange Act requires that futures contracts be traded on a regulated exchange. As a result, a futures contract that is traded off an exchange is illegal and unenforceable in a court of law. When Congress enacted this Act, the meaning of the terms 'future' and 'exchange' were relatively apparent and the over-the-counter derivatives business was in its infancy. In the 26 years since the statute's creation, however, the definitions of a swap and a future began to blur.

In 1998, the CFTC released its concept release on over-the-counter derivatives, which was perceived by many as a precursor to regulating these instruments as futures. Just the possibility of reaching this conclusion threatened to move significant portions of the business overseas. This led the Treasury Department, the Federal Reserve, and the SEC to ask Congress to enact a moratorium on the CFTC's ability to regulate these instruments until after the President's Working Group (PWG) could complete a study on the issue. As a result, Congress passed a six-month moratorium and in November 1999, the President's Working Group completed its unanimous recommendations on derivatives and presented Congress with its findings.

This legislation adopts many of the unanimous recommendations of the Working Group's report, including an exclusion for over-the-counter derivatives transacted on an electronic exchange and a clarification of the 'Treasury Amendment'. Another important recommendation of the Working Group was to authorize futures clearing facilities to clear over-the-counter derivatives in an effort to lessen systemic risk. This bill incorporates this finding.

The second major section of this legislation addresses regulatory relief for the futures

market. In February, the CFTC, under the leadership of Chairman Bill Rainer, issued a thoughtful proposal that would provide relief to futures exchanges and their customers. Instead of listing specific requirements for complying with the Act, the proposal would require exchanges to meet internationally agreed-upon core principals. The CFTC proposal tailors regulation for exchanges based on whether the underlying commodity can be manipulated or whether the users of the exchange are institutional. Our legislation incorporates this framework.

The bill's last major section addresses the Shad-Johnson jurisdictional accord, which banned single stock futures in 1982. The Working Group unanimously agreed that the Accord can be repealed if regulatory disparities are resolved between futures and securities. In December, Senator Gramm and I sent a letter requesting that the CFTC and the SEC make recommendations on reforming the Shad-Johnson Accord. The SEC and CFTC responded that, although progress had been made, the agencies could not resolve these issues before October. Disappointment with this answer led Senator Gramm and I to once again ask the agencies to attempt to resolve the problems surrounding lifting the ban. Unfortunately, an agreement within our legislative time-frame was not reached, and we have decided to move forward with our legislation.

This legislation would repeal the prohibition on single stock futures and allow these products to trade on either a CFTC-regulated futures exchange or an SEC-regulated securities exchange. Our bill also would provide for joint jurisdiction with each agency maintaining its core authorities over the trading of single stock futures. The legislation would further require that margin levels on these products be harmonized with the options market.

The goal of this legislation is to ensure that the United States remains a global leader in the derivatives marketplace. Already, the United States has lost its leadership role in the exchange-traded futures market to Europe, and the over-the-counter market may not be too far behind. Congress has an good opportunity to reverse this tide by enacting sound legislation this year. I am hopeful that our Committee can mark-up this legislation before the July 4th recess.

The importance of this legislation is reflected by the witnesses assembled before us today. Our first panel consists of the head of the President's Working Group, the Honorable Lawrence Summers, Secretary of the U.S. Department of the Treasury and the Honorable Alan Greenspan, Chairman of the Federal Reserve System. Our second panel consists of the Honorable Arthur Levitt, Chairman of the SEC and the Honorable Bill Rainer, Chairman of the CFTC. We look forward to their insights regarding their agencies' discussions on the Shad-Johnson Accord as well as other issues.

I now turn to my distinguished colleague, Senator Gramm, for his opening remarks.

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STATEMENT OF U.S. SENATOR PETER G. FITZGERALD

Joint Hearing On The Commodity Futures Modernization Act of 2000
Before The Committees On
Agriculture, Nutrition and Forestry
and
Banking, Housing and Urban Affairs

June 21, 2000

Good morning Chairman Lugar, Chairman Gramm, and distinguished members of the Committee on Agriculture, Nutrition and Forestry and the Committee on Banking, Housing and Urban Affairs. I am pleased to participate in this hearing on the proposed legislation to reauthorize the Commodity Futures Trading Commission ("CFTC") and to amend the Commodity Exchange Act ("CEA"). As an original co-sponsor of the Commodity Futures Modernization Act of 2000 ("CFMA"), I am proud to join Chairmen Gramm and Lugar in sponsoring legislation to provide much needed regulatory relief to the United States futures exchanges, to remove the eighteen-year-old ban on single stock futures, and to reduce government's role in the multitrillion-dollar derivatives markets. This legislation is long overdue and is vital for the modernization of the regulatory framework for the United States derivatives industry. The urgency of this legislation cannot be overly stressed. It is imperative that the United States financial markets be given broad flexibility to respond to the rapid changes in technology and product innovation occurring in the world derivatives markets. United States leadership in the derivatives markets must be maintained and regulatory burdens must not prevent our markets from keeping pace with the technological changes occurring in global markets.

I commend Chairman Lugar on his efforts to act swiftly to modernize the CEA and to implement the recommendations of the President's Working Group on Financial Markets ("PWG"). The

challenges involved in such an undertaking are enormous and I appreciate Chairman Lugar's thoughtful and comprehensive approach to this complex task. As Chairman of the Subcommittee on Research, Nutrition, and General Legislation, I have been actively involved in the evolution of the CFMA and am committed to working closely with Chairman Lugar, Chairman Gramm, and my other colleagues to ensure that the United States derivatives markets remain strong, competitive, and viable.

The CFMA provides an effective statutory framework for all three of the major issues that Congress must address during the CFTC reauthorization process: (1) the regulatory structure for entities covered by the CEA; (2) the framework for determining which derivative instruments should fall outside the CEA; and (3) the division of responsibility between the Securities and Exchange Commission ("SEC") and the CFTC for futures trading of contracts currently prohibited by the Shad/Johnson Jurisdictional Accord ("Accord"). These issues impact the regulation of derivatives in ways that would significantly alter the structure of the nation's financial markets and the commodity futures industry that is so vital to my home state.

Momentous changes are occurring in world financial markets and are coming with a swiftness unparalleled in history. As the pace of change continues to accelerate, it is vital that efficient regulation and legal certainty remain contemporaneous with the rapidly evolving innovations in these markets. If we do not quickly provide our derivatives markets with regulatory relief and certainty, we can fully expect a loss of our national competitiveness in the global marketplace.

The futures exchange markets are an integral part of the United States financial market structure and must, therefore, be given every opportunity to compete equally with the over-the-counter ("OTC")

derivative markets in product innovation and the competitive demands of the marketplace. We must ensure that the United States futures exchanges are not at a competitive disadvantage with the OTC derivatives markets. In this era of rapidly evolving electronic trading technology, United States exchanges must be given the regulatory flexibility to compete equally with the OTC derivatives markets in order to permit those exchanges to offer the most efficient markets in the world.

The CFMA codifies the recommendations of the PWG to enhance legal certainty for OTC derivatives by excluding from the CEA certain bilateral swaps entered into on a principal-to-principal basis by eligible participants. The market for OTC derivatives has exploded over the past two decades into a multi-trillion dollar industry. These large and sophisticated markets play an important role in the global economy and legal certainty is a critical consideration for parties to OTC derivative contracts. Accordingly, the CFMA recognizes that legal certainty for OTC derivatives is vital to the continued competitiveness of the United States markets and achieves this certainty by excluding these transactions from the CEA.

Federal regulation has not adapted to the rapid growth of the financial markets and today serves as a substantial restriction on market competitiveness and modernization. In order for the United States to maintain the most efficient markets in the world, regulatory barriers to fair competition must be removed to give the United States derivatives markets the regulatory flexibility to compete with global markets. Thus, there is an urgent need to reduce the inefficiencies of the CEA by removing the constraints on innovation and competitiveness and by transforming the CFTC into an oversight agency with less front-line regulatory functions.

We must ensure that our regulatory structure does not choose market winners and losers or push new markets and liquidity overseas. I believe the CFMA addresses these concerns and is responsive to the needs of the Chicago futures industry. The provisions for three kinds of trading facilities with varying levels of regulation provide needed flexibility to both traditional exchanges and electronic trading facilities by basing oversight of the futures markets on the types of products they trade and on the investors they serve. The futures exchange markets are an integral part of the United States financial market structure and must be given every opportunity to compete equally with the world markets in product innovation and the ever-changing demands of the marketplace.

Finally, the CFMA removes the Accord's prohibitions on the trading of single stock futures and small indices. The jurisdictional dispute between the CFTC and the SEC has for too long unfairly and unnecessarily prohibited the trading of futures on single stocks and small stock indexes. For almost two decades, this "temporary" agreement between Chairmen Shad and Johnson has operated to limit the growth of futures exchanges and to protect securities exchanges from competition. This in turn has denied the public an important investment choice.

Congress intended the Accord ban on single stock futures to be temporary. It was not intended as a permanent barrier to innovation and growth. Eighteen years have now passed since the Accord effectuated a political compromise to resolve a jurisdictional conflict between the SEC and the CFTC. During this time, these agencies have not fulfilled their promise to report to Congress on lifting the restriction. As a result, overseas exchanges have begun to trade futures on single stock equity securities and other innovative products. Stock index futures have matured into vital financial management tools that enable a wide variety of investment concerns to manage their risk of adverse price

movements. The options markets and swaps dealers offer customers risk management tools and investment alternatives involving both sector indexes and single stock derivatives. It seems only fair that futures exchanges be allowed to compete in this important market.

In November 1999, the PWG issued a report entitled *Over-the-Counter Derivatives Markets and the Commodity Exchange Act.* In that report, the PWG unanimously agreed that the Accord can be repealed if regulatory disparities are resolved between futures and securities regulation. Senators Lugar and Gramm sent a letter in December 1999 requesting the CFTC and the SEC to make legislative recommendations on reforming the Accord and gave them a February 2000 deadline. On March 2, 2000, the SEC and CFTC wrote Senators Lugar and Gramm stating that they had agreed that they would share jurisdiction on regulating stock futures and on some other issues, but that they could not resolve most of the problems before Congress adjourned for the year. This response resulted in a meeting with Senators Gramm and Lugar last month. At that meeting, the heads of these agencies promised to attempt to resolve the problems surrounding lifting the ban on single stock futures and report back to the Senators in two week with recommendations. However, once again, the agencies failed to reach a resolution.

The CFTC and the SEC have had eighteen years to provide Congress with a study on how best to regulate futures on single stocks. It is too late now to plead for more time. The Accord prohibitions have limited investor choice and have exposed market participants to legal uncertainty. No economic rationale appears to exist to restrict trading on single or index stocks. Accordingly, the CFMA lifts the ban on single and index stock futures restrictions to allow the marketplace to decide whether these instruments would be useful risk management tools and to enhance the ability of the U.S. financial markets to compete

in the global marketplace. The bill reforms the Accord to allow both futures and securities exchanges to trade these products under the jurisdiction of their current regulators. The CFMA also allows both the SEC and the CFTC to enforce violations of their respective laws regardless of whether the products are traded on a futures or securities exchange and requires that the agencies share necessary information for enforcement purposes.

The CFMA represents an arduous effort to remove burdensome regulatory structures and provide much needed legal certainty to the United States derivatives markets. This effort has produced comprehensive legislation that is designed to remove impediments to innovation and regulatory barriers to fair competition for the United States financial markets. Today's hearing addresses this legislative effort and I look forward to guidance from the panelists in discussing the important issues addressed in the CFMA.

RICK SANTORUM
PENNSYLVANIA

COMMITTEES:
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CHAIRMAN, SUBCOMMITTEE ON AIRLAND FORCES
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United States Senate
WASHINGTON, DC 20510-3804
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Statement of Senator Rick Santorum
Joint Senate Agriculture and Banking Committee Hearing
Commodity Futures Modernization Act of 2000
June 21, 2000

Chairmen Lugar and Gramm, I commend you for holding this hearing today on legislation to reauthorize the Commodities Future Trading Commission - S. 2697, the Commodity Futures Modernization Act of 2000. For the past five years, the process of CFTC reauthorization has been closely watched and scrutinized by many interested parties. After much hard work by the respective Committee Chairmen and their staff, and several hearings and a roundtable conducted by the Senate Agriculture Committee – today we have a long awaited and much anticipated piece of legislation.

Personally, this is a unique legislative undertaking as I come to this hearing today as a member of both the Senate Agriculture and Senate Banking Committees. Senator Johnson also shares this same distinction.

In crafting this bill, Chairmen Lugar and Gramm were faced with a Herculean task of trying to accommodate the concerns and wishes of so many parties with vested interests. And while the President's Working Group report served as a springboard, several key issues remained: notably, the repeal of the Shad-Johnson Accord and the regulation of single stock futures. Under this bill, the prohibition on single stock futures is repealed, and these products would be eligible to be traded on a futures exchange or a national securities exchange. A regulatory framework is also proposed under which both the CFTC and the SEC would have regulatory authority.

Chairmen, I look forward to the testimony of our distinguished witnesses as I, and my colleagues, continue to assess this legislation. And while we all bring to the table our regional concerns and interests - not unlike other agricultural debates - I believe S. 2697 is good starting point for our legislative consideration of CFTC reauthorization.

Statement of Senator John Edwards
before the
Senate Agriculture, Nutrition & Forestry Committee and the
Senate Banking, Housing & Urban Affairs Committee
Joint Hearing
June 21, 2000

CEA Reauthorization

Let me start by thanking the two Chairman for holding this hearing today. The issues before us are certainly complex, and I am pleased that we are taking time to hear from the federal regulators who have jurisdiction over these matters.

I come to this hearing with a basic premise that we have a responsibility to promote innovation in our financial markets and encourage the development mechanisms that promote efficiency and transparency. I also come to this hearing with a strong belief that we must balance our desire to promote innovation and market growth with the need to protect investors from fraud and other unscrupulous behavior. I believe that in many cases, we do our best work as legislators by letting market forces lead the way to increased efficiency and innovation. In many other cases, however, we have a critically important role in making sure that those who enter the market have the benefit of important consumer protections.

One of the issues we will be considering today is the Shad-Johnson Accord. In the face of our rapidly changing financial markets, many have called for the repeal of Shad-Johnson. However, unlike the historic consensus we see from the Working Group with regard to legal certainty for swaps, there is much debate about whether and how to permit the trading of single stock futures. I know that the CFTC and SEC have made some headway in their discussions, but there is much left to be done. I believe that there is a great deal at stake in this discussion, both for the markets and more importantly for investors.

I think we are doing a good thing here today by exploring the issue and by hearing from the regulators. The timing of the discussion is certainly appropriate, because we are considering many changes to the regulation of our financial markets. The timing is also appropriate because more people are investing in the markets. Thus, the changes we are considering will have a very significant impact on a larger number of investors than ever before.

I believe this cautions us against doing anything too quickly with regard to Shad-Johnson. We need to look to the efforts of the SEC and CFTC as they work on this issue. For us to rush forward without adequately addressing critical consumer protection and market integrity issues would only serve to threaten the success of the markets we seek to create.

On another note, I am pleased that the issue of legal certainty for swaps is taking such precedence in our discussions. This is one of the most critical issues facing the OTC derivatives market today. The Working Group's consensus recommendations provided an important framework and I am looking forward to seeing this issue addressed, hopefully in the near future.

I would also like to speak briefly about the importance of technological innovations in the financial markets. Technological innovation in the financial markets has put us in a position we could scarcely have imagined years ago and I believe we can expect this innovation to continue. We are seeing increased transparency and efficiency in our markets. Transactions are quicker, more accurate, and less expensive. These developments are also important because they reduce systemic risk. Certainly, as these innovations occur, we must make sure we fully understand how they coexist with our existing regulatory structure. We want to encourage the development of technologies that help our markets and assist investors in executing their transactions. I hope that as we examine the issues before us today we remain sensitive to the need to allow these new technologies to develop.

Again, I thank both Chairman Gramm and Chairman Lugar for holding these hearings, and I look forward to the testimony from our distinguished panel.

Statement of Senator Larry E. Craig
S. 2697, The commodity Futures Modernization Act of 2000
Join Hearing between the Committee on Agriculture, Nutrition and Forestry and Committee on Banking, Housing, and Urban Affairs.
June 21, 2000

Thank you Mr. Chairman.

I would first like to thank Chairman Lugar and Chairman Gramm for their work in introducing S. 2697, The Commodity Futures Modernization Act of 2000, and for holding this hearing today. Much time has been put into the reauthorization of the Commodity Exchange Act (CEA). At times the process has been slow as the Committee tried to encourage those involved to work together to find common ground.

As futures exchanges continue to grow, we must assure that the United States exchanges remain competitive or we could lose business overseas. I am pleased to see that S. 2697 modernizes the regulation of exchange traded futures, and establishes legal certainty for over-the-counter derivatives transactions. This legislation also reforms the outdated Shad-Johnson agreement. While everyone may not be satisfied with this provision of the bill, I believe some reform is necessary.

I applaud the committee's effort to find common ground through over a year of hearings and many meetings with industry. While everyone may not be happy with every detail of the legislation, I believe this bill represents a very fair compromise and would ask that the Chairman add my name to the list of cosponsors of S. 2697.

With that, I look forward to hearing from our distinguished witnesses and hope that their concerns can be addressed soon so this bill can move forward in a timely manner.

EMBARGOED UNTIL 10:00 A.M. (EDT)
Text as prepared for Delivery
June 21, 2000

TREASURY SECRETARY LAWRENCE H. SUMMERS
JOINT SENATE COMMITTEES ON AGRICULTURE, NUTRITION, AND FORESTRY
AND
BANKING, HOUSING AND URBAN AFFAIRS

Chairman Lugar, Chairman Gramm, Senator Harkin, Senator Sarbanes, Members of these Committees, thank you for giving me the opportunity to discuss the Commodity Futures Modernization Act with you today. This legislation represents an important step in the modernization of the regulatory structure for the U.S. derivatives market. Let me also take this opportunity to commend both Chairmen Gramm and Lugar for the leadership and interest you have shown in this area.

The over-the-counter derivatives market is an important component of the American capital markets and a powerful symbol of the kind of innovation and technology that has made the American financial system as strong as it is today. Operating within a proper and appropriate framework of legal certainty, we believe that the benefits to the U.S. economy of OTC derivatives would continue to grow. For example:

- By helping businesses and financial institutions to hedge their risks more efficiently, derivatives enable them to pass on the benefits of lower costs to American consumers and businesses.

- By allowing for the transfer of unwanted risk, derivatives can promote more efficient allocation of capital across the economy, increasing productivity.

- By providing better pricing information, derivatives can help promote greater liquidity and efficiency in the underlying cash markets.

- Finally, by enabling more sophisticated management of assets, including mortgages, consumer loans, and corporate debt, derivatives can help lower mortgage payments, insurance premiums, and other financing costs for American consumers and businesses.

Clearly, it is vital that we work together to provide a regulatory framework that will ensure the continuation of a healthy and well-functioning OTC derivatives market. While the

current framework here in the U.S. remains outdated, markets overseas are developing in a legal and regulatory environment that allows greater efficiency and transparency.

Unless our laws and regulations relating to derivatives are modernized, we run the risk that innovation will be stifled by the absence of legal certainty, depriving the American economy of the benefits that the derivatives markets can provide, and hampering the efforts of our OTC and exchange-traded markets and businesses to compete globally.

Let me divide my remarks into two parts:

- First, I will begin by reviewing the findings of the President's Working Group on Financial Markets and our guiding principles for modernization of the U.S. legal and regulatory framework for OTC derivatives.

- Second, I will discuss in detail S. 2697, the Commodity Futures Modernization Act, and our position with respect to the bill's treatment of OTC derivatives, regulatory relief for the futures exchanges, and the repeal of the Shad-Johnson restrictions on the trading of single stock futures.

I. Modernization of our Legal and Regulatory Framework for Derivatives.

As a result of concerns about the regulatory structure of U.S. derivatives markets, Congress requested that the President's Working Group study the OTC derivatives market and recommend what changes were required. The Working Group worked on the assumption that legislative action would be required within a timeframe appropriate to the growing importance of the OTC derivatives market – and taking into account this market's potential contribution to the efficient functioning of the American financial sector and to that of the economy as a whole.

The Working Group had four primary objectives for legislation in this area:

- **To reduce systemic risk** in the OTC derivatives market by removing legal impediments to the development of clearing systems and ensuring that those systems are appropriately regulated.

- **To promote innovation** in the OTC derivatives market by providing legal certainty for OTC derivatives and electronic trading systems. This would strengthen the overall legal framework governing the OTC derivatives market that, in turn, would stimulate even greater competition, transparency, and efficiency and deliver stronger benefits to U.S. consumers and businesses.

- **To protect retail customers** by ensuring that appropriate regulations are in place to deter unfair practices in all markets in which they participate and by closing existing legal loopholes that allow unregulated entities to pursue such unfair practices.

- **To maintain U.S. competitiveness** by providing a modernized framework that will lead those engaged in the financial services industry to continue the operations of their businesses

in the United States, and thereby help to assure the continued leadership of our capital markets.

In addition, because the scope of the legislation being considered extends beyond the areas considered in detail by the Working Group, we would add a fifth important objective:

- **To protect the integrity of the markets** underlying the derivatives in question – in particular, the markets for securities.

The Working Group made a series of unanimous recommendations with respect to furthering these objectives.

The challenge before these Committees and the Congress is to establish a regulatory regime that will strike a balance between allowing the economy to realize more fully the benefits of derivatives and, at the same time, ensuring the integrity of the underlying markets, providing appropriate protection for retail customers, and where possible, taking steps to mitigate systemic risk.

At the same time, we need to recall that the emergence of these markets has occurred during an era of unprecedented economic growth and prosperity. It is to be expected that in times of distress some participants in these markets, as in other financial markets, will be adversely affected. What needs to be protected, however, is the financial system as a whole, and not individual institutions.

We believe that the Working Group's recommendations with respect to clearing and those designed to enhance transparency and legal certainty and to clarify the treatment of derivatives in the case of bankruptcy or insolvency can contribute to enhancing the stability of the system more broadly.

II. The Commodity Futures Modernization Act.

Mr. Chairman, in light of the Working Group's recommendations, we generally support this bill and are committed to working with these Committees and the Congress to facilitate the enactment of this important legislation.

Moreover, we believe it is important to move forward with appropriate legislation as soon as possible. In the absence of an updated legal and regulatory environment, needless systemic risk might jeopardize the broader vitality of the American capital markets. We also risk an erosion of competitiveness of American financial markets, with an increasing amount of business moving offshore to jurisdictions where the framework has kept up with the pace of change.

In that regard, we believe that this bill incorporates the recommendations of the Working Group with respect to OTC derivatives which, if enacted, would promote greater legal certainty for these instruments and help to advance all of the Working Group's objectives with respect to these instruments.

I would like to address the three major areas of the bill:

- First, the bill's approach to OTC derivatives;
- Second, the regulatory relief provisions of the bill; and
- Finally, the provisions of the bill providing for the repeal of the Shad-Johnson restrictions on the trading of single stock futures.

OTC derivatives

Let me first address the bill's approach to OTC derivatives. This bill largely incorporates the recommendations of the Working Group with respect to OTC derivatives. We strongly support such provisions. We do, however, have one important concern in this area.

The bill provides a broad exclusion from the securities laws for swaps, including, in particular, swaps based on securities. We are very much supportive of the objective of removing any unnecessary regulation. Let me caution, however, that there is an important distinction between the securities laws and the commodities laws in that the securities laws do not impede legal certainty. Thus, this is not a legal certainty issue.

As a general matter, we do not believe that swaps should be regulated as securities. However, it is important to preserve prohibitions against insider trading, fraud, and manipulation and also to preserve other measures which are demonstrably necessary to protect retail customers.

We are concerned that the provisions, as currently drafted, could have the unintended consequence of interfering with these vital protections that are now in place for the securities markets. I would also note that it will be important to clarify the definition of "swap agreements" so that it does not extend to certain transactions that are not customarily considered swaps and thereby raise regulatory issues that swaps do not.

Because the provisions, as currently drafted, have the potential to impact the underlying securities markets, we believe that it is imperative that they be amended to address these concerns.

Regulatory Relief

Let me next turn to the regulatory relief proposals contained in the bill. The Treasury Department continues to support the view that it is appropriate to review, from time to time, existing regulatory structures to determine whether they continue to serve valid regulatory functions. Like the OTC markets, exchange trading of derivatives should not be subject to regulations that do not have a public policy justification.

In that regard, the CFTC has recently released its regulatory relief proposal for public comment. We will be submitting a formal comment letter on this proposal in the near future.

Broadly, however, we are supportive of the CFTC's efforts to provide appropriate regulatory relief to the futures exchanges, consistent with the public interest.

With regard to the specific regulatory relief provisions of the bill as currently drafted, we have a concern with certain provisions that permit "exempt boards of trade". To encourage innovation and competition, the Working Group recommended an exclusion from the Commodity Exchange Act for electronic trading systems that satisfy certain criteria. Although the bill contains provisions to enact this exclusion, it also contains a statutory exemption for certain electronic and physical trading facilities. These "exempt boards of trade" would remain subject to the CEA's "exclusive jurisdiction" clause, thereby precluding regulatory oversight by other agencies.

To be clear: there are provisions in the bill as currently drafted which could have the perverse consequence of creating the situation where protections that are present with respect to off-exchange trades would not be present with respect to transactions that took place on an exchange. These matters have particular importance with respect to the integrity of the government securities markets. Any reduced confidence in such integrity could lead to higher financing costs for the Treasury and thus an increased burden on American taxpayers.

- The potential impact of this provision on the integrity of the government securities market is of particular concern to the Treasury Department. In 1986, Congress passed the Government Securities Act to provide an appropriate regulatory framework for the government securities markets in direct response to a number of specific problems in the unregulated portion of this market. In 1993, in response to incidents of wrongdoing in Treasury auctions, Congress strengthened these laws to provide additional protection against market abuses.

- This has the potential to undermine the laws that Congress put in place in recent years that were designed to uphold and strengthen the integrity of the government securities market.

For these reasons, we strongly recommend that those provisions of the bill related to exempt boards of trade be removed or amended to preclude the trading of securities-related products on those systems.

The Shad-Johnson Accord.

Let me now turn to the question of restrictions on trading of individual stocks under the Shad-Johnson accord. The members of the Working Group agreed that the current prohibition on single-stock futures could be repealed if issues about the integrity of the underlying securities markets and regulatory arbitrage are resolved. Our view remains unchanged.

The provisions contained in this bill regarding futures on non-exempt securities (corporate stocks and bonds) are a good starting point, although a number of issues remain unresolved. The bill addresses some of the customer protection and enforcement concerns identified by the CFTC, the SEC, and others as necessary conditions for repealing the prohibition on single-stock futures.

However, there are a number of concerns that the regulatory agencies consider important, but that have not been resolved in the legislation. We hope that the SEC and CFTC can provide specific comments on these issues in the near future so that they can be incorporated into this bill.

In addition, certain issues related to the harmonization of margin requirements will need to be clarified. While we do not see the need to establish margin requirements in statute, it will be important to establish margin levels that do not encourage regulatory arbitrage or lead to a substantial increase in leverage in our financial system.

While we have no objection to the introduction of single-stock futures, it is vitally important that the integrity of the underlying markets be preserved, and that these instruments not be used as a means to avoid the regulations of the cash markets. Therefore, we continue to be supportive of efforts by the SEC and CFTC to reach an agreement on a regulatory framework for these products that preserves the integrity of the underlying securities markets.

However, if these issues cannot be resolved on a timely basis, we believe that it is important to move forward with legislation designed to clarify the legal certainty for OTC derivatives.

The Importance of Clarifying the Treatment of Financial Contracts in Bankruptcy.

Before closing, although it is not part of this bill, I would like to take this opportunity to strongly urge Congress to adopt the President's Working Group recommendations regarding the treatment of certain financial contracts, including OTC derivatives, in cases of bankruptcy or insolvency.

Rarely are there tangible steps the government can take that could have a meaningful impact on the mitigation of systemic risk. Enacting the recommendations of the Working Group designed to clarify the treatment of these instruments in cases of bankruptcy or insolvency is one of those steps.

By establishing a framework through which creditors and counterparties can work out a swift resolution in cases of bankruptcy or insolvency, enactment of these recommendations can serve to reduce the impact of the failure of any one institution on the stability of the system more broadly.

V. Conclusion

In conclusion, we have an opportunity to advance legislation which will create a modern legal and regulatory framework for OTC derivatives. S. 2697 is certainly a significant step in the right direction. We look forward to working with members of these Committees, and with other members of Congress to address our remaining concerns with the bill and to pass legislation that will help to reduce systemic risk, promote innovation, protect retail customers, maintain U.S. competitiveness, and protect the integrity of our securities markets.

For release on delivery
10:00 a.m. EDT
June 21, 2000

Statement of

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Agriculture, Nutrition, and Forestry

and the

Committee on Banking, Housing, and Urban Affairs

United States Senate

June 21, 2000

I am pleased to be here to present the Federal Reserve Board's views on the Commodity Futures Modernization Act of 2000 (S. 2697). My testimony today will be largely identical to testimony that my colleague Patrick Parkinson delivered on behalf of the Board last week to the House Subcommittee on Risk Management, Research, and Specialty Crops. The Board continues to believe that such legislation modernizing the Commodity Exchange Act (CEA) is essential. To be sure, the Commodity Futures Trading Commission (CFTC) has recently proposed issuing regulatory exemptions that would reduce legal uncertainty about the enforceability of over-the-counter (OTC) derivatives transactions and would conform the regulation of futures exchanges to the realities of today's marketplace. These administrative actions by no means obviate the need for legislation, however. The greatest legal uncertainty affecting OTC derivatives is in the area of securities-based transactions, to which the CFTC's exemptive authority does not extend. Furthermore, as events during the past few years have clearly demonstrated, regulatory exemptions carry the risk of amendment by future commissions. If our derivatives markets are to remain innovative and competitive internationally, they need the legal and regulatory certainty that only legislation can provide.

In my remarks today I shall focus on three of the areas that the legislation covers: (1) OTC derivatives; (2) regulatory relief for U.S. futures exchanges; and (3) repeal of the Shad-Johnson restrictions on the trading of single-stock futures.

OTC Derivatives

In its November 1999 report, *Over-the-Counter Derivatives and the Commodity Exchange Act*, the President's Working Group on Financial Markets (PWG) concluded that OTC derivatives transactions should be subject to the CEA only if necessary to achieve the public policy objectives of the act--deterring market manipulation and protecting investors against fraud

and other unfair practices. In the case of financial derivatives transactions involving professional counterparties, the PWG concluded that regulation was unnecessary for these purposes because financial derivatives generally are not readily susceptible to manipulation and because professional counterparties can protect themselves against fraud and unfair practices. Consequently, the PWG recommended that financial OTC derivatives transactions between professional counterparties be excluded from coverage of the CEA. Furthermore, it recommended that these transactions between professional counterparties be excluded even if they are executed through electronic trading systems. Finally, the PWG recommended that transactions that were otherwise excluded from the CEA should not fall within the ambit of the act simply because they are cleared. The PWG concluded that clearing should be subject to government oversight but that such oversight need not be provided by the CFTC. Instead, for many types of derivatives, oversight could be provided by the Securities and Exchange Commission (SEC), the Office of the Comptroller of the Currency, the Federal Reserve, or a foreign financial regulator that the appropriate U.S. regulator determines to have satisfied its standards.

The provisions of S. 2697 that address OTC derivatives are generally consistent with the PWG's conclusions and recommendations. The Federal Reserve Board is troubled, however, by a provision that might leave uncertainty about whether some electronic trading systems for financial contracts between professional counterparties were subject to the CEA. Specifically, restricting exclusions for transactions conducted on electronic trading facilities to "bona fide" principal-to-principal transactions is unnecessary and undesirable. This restriction could be construed to preclude a counterparty from entering into "back-to-back" principal-to-principal

transactions, that is, from using an excluded electronic trading system to hedge transactions executed outside the trading system. We can identify no public policy reason for precluding such back-to-back transactions. Doing so would discourage the use of electronic trading systems and thereby inhibit realization of the improvements in market efficiency and transparency that such systems promise to deliver.

Regulatory Relief for U.S. Futures Exchanges

The PWG did not make specific recommendations about the regulation of traditional exchange-traded futures markets that use open outcry trading or that allow trading by retail investors. Nevertheless, it called for the CFTC to review the existing regulatory structures, particularly those applicable to financial futures, to ensure that they remain appropriate in light of the objectives of the CEA. In February, the CFTC published a report by a staff task force that provided a comprehensive review of its regulatory framework and proposed sweeping changes to the existing regulatory structure. We understand that the regulatory relief provisions of S. 2697 are intended to codify these proposals.

Using the same approach as the PWG, the CFTC has evaluated the regulation of futures exchanges in light of the public policy objectives of deterring market manipulation and protecting investors. When contracts are not readily susceptible to manipulation and access to the exchange is limited to sophisticated counterparties, the CFTC has proposed alternative regulatory structures that would eliminate unnecessary regulatory burden and allow domestic exchanges to compete more effectively with exchanges abroad and with the OTC markets. More generally, the CFTC proposes to transform itself from a frontline regulator, promulgating

relatively rigid rules for exchanges, to an oversight agency, assessing exchanges' compliance with more flexible core principles of regulation.

The Federal Reserve Board supports the general approach to regulation that was outlined in the CFTC's proposals. For some time the Board has been arguing that the regulatory framework for futures trading, which was designed for the trading of grain futures by the general public, is not appropriate for the trading of financial futures by large institutions. The CFTC's proposals recognize that the current "one-size-fits-all" approach to regulation of futures exchanges is inappropriate, and they generally incorporate sound judgments regarding the degree of regulation needed to achieve the CEA's purposes.

Furthermore, the Board generally supports codification of the CFTC's proposals so as to provide the exchanges with greater certainty regarding future regulation. However, the Treasury Department is concerned that the exempt board of trade provisions might have unintended consequences that could reduce the effectiveness of the existing regulatory framework for the trading of government securities. To facilitate expeditious passage of legislation, it thus may be prudent to limit the codification of the exempt board of trade provisions, at least so that markets currently regulated under the Government Securities Act of 1986 are not affected. In such a scenario, the CFTC could address any unintended consequences for the regulation of government securities by changing the terms of its exemptions.

Single-Stock Futures

The PWG concluded that the current prohibition on single-stock futures (part of the Shad-Johnson Accord) can be repealed if issues about the integrity of the underlying securities markets and regulatory arbitrage are resolved. The Board believes that S. 2697 provides an

appropriate framework for resolving these issues. Such instruments should be allowed to trade on futures exchanges or on securities exchanges, with primary regulatory authority assigned to the CFTC or the SEC, respectively. However, the bill recognizes that the SEC should have authority over some aspects of trading of these products on futures exchanges. The scope of the SEC's authority can and should be resolved through negotiations between the CFTC and the SEC. The Congress should continue to urge the two agencies to settle their remaining differences so that investors have the opportunity to trade single-stock futures.

If it would facilitate repeal of the prohibition, the Federal Reserve Board is willing to accept regulatory authority over levels of margin on single-stock futures, as provided in S. 2697, so long as the Board can delegate that authority to the CFTC, the SEC, or an Intermarket Margin Board consisting of representatives of the three agencies. The Board understands that the purpose of such authority would be to preserve the financial integrity of the contract market and thereby prevent systemic risk and to ensure that levels of margins on single-stock futures and options are consistent. The Board would note that, for purposes of preserving financial integrity and preventing systemic risk, margin levels on futures and options should be considered consistent, even if they are not identical, if they provide similar levels of protection against defaults by counterparties, taking into account any differences in (1) the price volatility of the contracts, (2) the frequency with which margin calls are made, or (3) the period of time within which margin calls must be met.

Conclusion

This bill reflects a remarkable consensus on the need for legal certainty for OTC derivatives and regulatory relief for U.S. futures exchanges, issues that have long eluded

resolution. These provisions are vitally important to the soundness and competitiveness of our derivatives markets in what is an increasingly integrated and intensely competitive global economy. The Federal Reserve Board trusts that remaining differences regarding single-stock futures and the potential application of the securities laws to OTC derivatives can be resolved quickly and this important piece of legislation can be expedited through this Congress.

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TESTIMONY OF

ARTHUR LEVITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING S. 2697,
THE COMMODITY FUTURES MODERNIZATION ACT OF 2000

BEFORE
THE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY
AND
THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

JUNE 21, 2000

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

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Chairman Lugar, Chairman Gramm, and Members of the Committees:

I am pleased to testify today on behalf of the Securities and Exchange Commission ("SEC" or "Commission") as you consider S. 2697, the Commodity Futures Modernization Act of 2000. The bill's principal focus is on lifting the ban on single stock futures and the much needed modernization of our futures laws as well as the provision for legal certainty for over-the-counter ("OTC") derivatives. One of its core provisions, however, potentially could result in fundamental and counterproductive deregulation of our securities markets.

For over six decades, our securities laws have defined the Commission's mission: To insure integrity and competition in our markets and to protect investors. Today, Americans invest in our capital markets in greater numbers than anywhere else in the world, a testament to the confidence that the securities laws have helped instill.

I can appreciate that to some our securities laws may appear to be just more government regulation. But to study our securities laws is to discover the rich history of U.S. financial markets. Your predecessors did not write these laws in a vacuum. They enacted these statutes in response to significant problems that cried out for practical solutions.

History proves that these laws have worked for the securities markets. Not only our securities markets, but also our derivatives markets, such as the options markets, have thrived under this framework. To me, the question posed by this bill is whether the benefits of the securities laws that investors have come to expect should continue to

apply to these markets. Unequivocally, the Commission's answer to that question is yes.

My testimony today focuses on two key topics. First, I address OTC derivatives markets. Second, I address the competition, investor protection, and market integrity issues raised by single stock and stock index futures.

I. Legal Certainty for OTC Derivatives Markets

As you know, last year the President's Working Group on Financial Markets ("Working Group") issued a report on OTC Derivatives Markets and the Commodity Exchange Act ("OTC Derivatives Report").[1] That Report contained several recommendations related to legal certainty for OTC derivatives products. These products play a critical role in our capital markets. I can think of few more important issues for Congressional consideration than legislation to implement the recommendations by the Working Group to give legal certainty to the OTC derivatives market. Accordingly, the Commission reiterates its strong support for implementation of the recommendations by the Working Group related to legal certainty for the markets that trade these products.

OTC derivatives markets are enormous in size[2] because these contracts are critical to risk management for a vast array of businesses. In studying these markets, the Working Group's task was fairly narrow – to determine whether the Commodity Exchange Act ("CEA"), which had introduced substantial risk that such contracts could be voided, provided an appropriate regulatory framework for these markets. The Working Group unanimously concluded that for certain OTC derivatives the CEA was not the appropriate framework and that steps needed to be taken to ensure that the CEA did not stifle the natural development of these markets. For a more detailed discussion of the Working Group's recommendations, I refer you to prior Commission testimony.[3]

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1 Report of the President's Working Group on Financial Markets, Over-the-Counter Derivatives Markets and the Commodity Exchange Act (Nov. 1999).

2 According to data from the Bank for International Settlements, at the end of June 1999, the total estimated notional amount of outstanding OTC derivative contracts was $81.5 trillion. The Global OTC Derivatives Market at end – June 1999, 45/1999E (Nov. 25, 1999) <http://www.bis.org/press/index/htm>.

3 *See* Testimony of Annette L. Nazareth, Director, Division of Market Regulation, U.S. Securities and Exchange Commission, Concerning the Report to Congress on Over-the-Counter Derivatives Markets and the Commodity Exchange Act by the President's Working Group on Financial Markets, Before the Senate Comm. on Agriculture, Nutrition, and Forestry (Feb. 10, 2000). *See also* Testimony of Annette L. Nazareth, Director, Division of Market Regulation, U.S. Securities and Exchange Commission, Concerning Recent Recommendations by the President's Working Group on Financial Markets, Before the House Comm. on Banking and Financial Services (Apr. 11, 2000); Testimony of Annette L. Nazareth, Director, Division of Market Regulation, U.S. Securities and Exchange Commission, Concerning the Report to Congress on Over-the-Counter Derivatives Markets and the Commodity Exchange Act by the President's Working Group on

It is worth underscoring the significance of the consensus achieved by the Working Group. Four of the leading U.S. financial regulators unanimously agreed that the Report's recommendations, which reflected their combined regulatory expertise, urgently required implementation. The Commission is very supportive of the Committees' efforts to further the goals of the Working Group. However, as we have stated in the past, it is not necessary to link resolution of all issues raised in the bill to passage of the much needed provisions on legal certainty for OTC derivatives.

S.2697, as introduced, differs from the Working Group's recommendations regarding legal certainty in several key respects. The Commission staff would be happy to discuss those differences in detail with you or your staff and provide technical assistance to the Committees. But today, I want to focus on a provision in the bill that would have significant implications for the integrity of the market for a wide-range of securities-based derivatives. Section 23 of the bill would exclude from the securities laws – and their widely enjoyed protections – any swap agreement. We see no public policy justification for this far-reaching provision.

Concerns about legal uncertainty regarding swaps arose only because, if swaps contracts were construed as futures under the CEA, they would be illegal and voidable if they were traded off of an exchange. This unique structure of the CEA, coupled with the issuance by the CFTC of a concept release suggesting a new regulatory framework for swaps, were what brought the legality of these transactions into question. This is what prompted the other members of the Working Group to call for a moratorium on CFTC rulemaking in this area and led to the Working Group's study of OTC derivatives markets and the CEA.

By contrast, similar issues of legal certainty do not arise under the securities laws. Nothing in the securities laws has impaired the growth of the $80 trillion swap business. The marketplace has structured these products to comply with the securities laws with no adverse impact on their economic structure.

In addition, the SEC has taken a measured approach in the swaps area. In part, this is because the SEC does not have blanket authority over swaps or other derivatives. Generally, for the SEC to assert jurisdiction over a financial product, that product must meet well-established tests of what is a security. Under these tests, it has been recognized from the earliest days of the securities laws that over-the-counter options on securities were themselves securities, even if documented as swaps. Moreover, the Commission by and large has brought enforcement actions related to swaps only in clear cases of fraud. The exclusion of swaps from the CEA will have no impact whatsoever on the Commission's measured approach to these derivative products.

Financial Markets, Before the Subcomm. on Risk Management, Research and Specialty Crops, House Comm. on Agriculture (Feb. 15, 2000).

Furthermore, when the industry has asked the SEC to take action in the OTC derivatives area, we have responded promptly with creative initiatives, such as the flexible, voluntary regulatory framework for OTC derivatives dealers -- commonly referred to as BD Lite. The Working Group never suggested that achieving legal certainty entailed removing all regulation involving derivative products. The Working Group concluded only that the CEA was not the proper statute to govern certain swaps. The real issue was removing these products from a law that called their validity into question. Nothing in the Report called for the elimination of other existing financial regulations, and the protections they provide.

The bill's language in Section 23 on what products are defined as swaps and therefore excluded from the securities laws is expansive and vague. OTC options on securities could be characterized as swaps. Indeed, any exchange of cash for a security could be drawn up as a swap and therefore arguably excluded from the securities laws. Therefore, this provision of the bill would result in a wholesale removal of SEC oversight over a wide array of securities products. The risks to this approach could not be more clear. Those seeking to avoid long-established investor and market integrity protections of the securities laws could do so by merely labeling the transactions as "swaps." The potential consequences of this gaping loophole in the application of our long established securities law protections could be significant.

Because of the breadth of related provisions in Section 23, the legislation, as currently drafted, also threatens important aspects of the Commission's enforcement program. In its apparent effort to ensure that swaps would be excluded from SEC jurisdiction, the legislation includes a "catch-all" limitation on SEC authority. The language of this catch-all provision could be interpreted to curtail Commission authority in areas where it traditionally has acted to protect investors. In particular, the catch-all could undermine SEC authority to act against perpetrators of Ponzi schemes, who frequently target the kinds of novice investors recently drawn into the markets in great numbers. It also could be applied to inhibit the SEC's effort to combat a troubling resurgence in insider trading.

Thus, while the SEC strongly supports the Working Group's recommendations to provide legal certainty for OTC derivatives regarding the CEA, we cannot support the bill's attempt to go beyond the carefully considered recommendations of the Working Group.

The Commission continues to strongly support the implementation of the Working Group's recommendations that are designed to provide legal certainty for the OTC derivatives markets. Those recommendations should be implemented immediately. We appreciate the efforts of these Committees in furtherance of this goal, and we are committed to working with you as modifications are made to this bill.

II. Lifting the Ban on Single Stock Futures

The Commission supports lifting the Shad-Johnson ban on single stock futures, once the regulatory issues underlying that ban are resolved. This year the Commission devoted tremendous staff resources to designing a legislative framework under which single stock and narrow-based stock index futures could trade. As a result of our efforts, the Commission strongly believes that these products can trade under the regulatory system that I will outline for you today. That is not to say that it was easy to formulate this system. Disparities between futures and securities regulation, as well as the ease with which single stock futures were expected to substitute for securities, made this a difficult task.

Among other things, the Commission staff focused on issues raised by the Working Group. In its OTC Derivatives Report, the Working Group identified several issues that would need to be addressed before trading of single stock futures can begin. Furthermore, the Working Group noted that these issues were best resolved by the Commission and the CFTC. Others, including the Chairmen of these Committees, also urged the SEC and CFTC to determine cooperatively how to regulate single stock futures.

I want to highlight that, although Chairman Rainer and I did not reach agreement on all aspects of a regulatory framework for single stock futures, we did reach agreement on fundamental principles for creating such a framework. We relayed these principles to you in a letter dated March 2.[4] Most important among these principles was that, given the legitimate regulatory interests of both the SEC and CFTC in these products, single stock futures should be subject to joint regulation by both agencies. The significance of this point should not be understated. This is a positive step forward from outdated notions of exclusive jurisdiction and the view that because a product can be considered a "future" it should be solely regulated by the CFTC. It reflects movement towards truly modern financial regulation – regulation that recognizes the need for agencies with legitimate regulatory interests, and expertise, in a product to participate in that product's oversight.

A. Requirements for a Legislative Framework

1. General Principles for Markets that are Competitive, Fair, and Free From Fraud and Manipulation

The process of working through important issues with the CFTC led the Commission staff to identify requirements for legislation to permit the trading of single stock futures. Contrary to what some have suggested, this is not at base a turf battle between the futures and options markets and the agencies that regulate them. There are fundamental issues of market integrity and investor protection at stake. For this reason,

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[4] Letter from the Honorable Arthur Levitt, Chairman, SEC, and the Honorable William Rainer, Chairman, CFTC, to the Honorable Phil Gramm, Chairman, Senate Committee on Banking, and the Honorable Richard Lugar, Chairman, Senate Committee on Agriculture (March 2, 2000).

we should move forward in a reasoned and principled manner, as we consider how to permit an entirely new product to trade. If legislation is crafted correctly, markets will compete and regulators will cooperate. I think it would be useful to review the components we believe are critical for an appropriate legislative framework.

Shared Jurisdiction

First, single stock futures are undeniably a substitute for stocks and stock options, and are fully expected to be a retail product. Thus, the framework must recognize the legitimate interests of both the SEC and the CFTC in regulating these products. Single stock futures possess attributes of both securities and futures contracts. The nature of single stock futures makes joint regulation appropriate, and exclusive jurisdiction ill-advised. Shared jurisdiction and joint regulation entail both recognizing each agency as best qualified to apply the key components of the laws it administers, and coordinating the agencies' efforts to ensure efficient market regulation that is not duplicative or overly burdensome.

At the practical level, this means ensuring that both agencies have the authority to carry out core functions, and that both encounter no jurisdictional barriers in the suppression of fraud and manipulation. Yet, at the same time, mechanisms should be devised to coordinate on certain costly issues so that the traditional regulator takes the lead.

Encourage Fair Competition

Second, the framework must encourage fair competition among markets. We do not want a framework that lets differences in regulation determine winners and losers. Any legislation should allow both securities and futures markets to enter the competitive fray, but should not give any type of market an artificial competitive advantage. This involves not only stating that some specific regulations should be harmonized, but providing a mechanism for the CFTC and SEC to do so on an ongoing basis as the markets evolve.

For example, mechanisms must be put in place so that both the SEC and the CFTC can act to harmonize the margin requirements across markets on an ongoing basis. Otherwise, the market with the more lenient margin requirements will have an artificial competitive edge. Markets should not compete for customers based on how much leverage they are allowed to provide those investors. Competition should be based on better products, services, and prices – not on regulatory differences.

The legislation also should require coordinated clearing of single stock futures so that a future purchased on one exchange could be offset on another exchange that trades the same type of future. This would allow the multiple listing of the same single stock future product on multiple exchanges and promote price competition in ways that we have recently seen narrow spreads in the options markets. Coordinated clearing also makes it more viable for new markets to enter the competitive arena over time. Without

coordinated clearing, new markets will not be able easily to offer the same products as competitors.

Protect Investors

Third, the framework must acknowledge that single stock futures will be retail products. While extremely complex derivative products might not attract retail customers, a simple future on a share of a blue chip stock is the type of product that is sure to do so. Accordingly, legislation must maintain the SEC's ability to protect investors and to maintain integrity of the markets on which they trade. For this reason, the SEC should have clear and direct authority over the markets and market participants that trade single stock futures.

I think it is important to explore a few examples of what might happen, if the SEC does not have such authority.

In the securities markets, recommendations that brokers make to investors are governed by the suitability rules of self-regulatory organizations subject to SEC oversight. If the securities law principle of suitability is not applied to single stock futures, a broker could recommend such a product to a retiree with no liability under the securities laws. The customer protection regime is quite different under the futures laws. Investors receive a one-time disclosure document informing them that they can lose money on futures. What are the implications of these differences? I believe they are quite significant. Consider that in the vast majority of cases the same broker who sells the retiree securities will also be licensed to sell single stock futures. Does anyone believe that investors will understand that the protections they enjoy when they purchase one product from their broker will not also apply to the other? And worse yet, could brokers have an incentive to offer the riskier single stock futures to investors if they could do so without the suitability responsibilities that attach to the sale of securities? I see no public policy reason to create a framework with such an inexplicable disparity in investor protections.

Next, consider a corporate insider who learns that his company is about to receive an unsolicited bid to be taken over. The insider buys a substantial amount of single stock futures on a futures exchange and earns huge profits on the transaction, which he plans to send to an offshore bank. This case involves insider trading that takes money out of the pockets of investors who did not have this information. This is exactly the type of situation that the Commission needs its full authority to address. Without direct authority over the futures exchange or a requirement for insider reporting, the SEC may have difficulty ever learning of the futures purchase by the insider. Even if the SEC were notified of the suspicious futures transactions, if we have to seek CFTC permission to proceed with an investigation or enforcement action, the SEC loses precious time and could likely lose the ability to freeze the insider's U.S. assets. Such activities could destroy years of Commission efforts to protect investors from insider trading abuses. Indeed, I think back to some of our most celebrated insider trading cases. Would we

want a system that would risk the successful prosecution of such cases merely because they involved single stock futures?

Investors also currently rely on the Commission to protect them from unscrupulous, or even just sloppy, practices by investment advisers and mutual fund managers. A bill should not introduce single stock futures into the mix of investment opportunities that an investment adviser may recommend to his or her clients or that a portfolio manager may purchase for the mutual fund he or she manages without regulation by the SEC. This would leave investors in funds consisting of single stock futures without the same protections that investors in mutual funds have enjoyed since 1940.

These are only a few examples, but I hope they illustrate why the investor protections contained in the securities laws should be extended to single stock and narrow-based stock index futures. Please recognize that the SEC's instruments for investor protection are interlinked. Enforcement actions coupled with inspections and the ability to promulgate new regulations, when necessary, are essential ingredients of ensuring the integrity of America's markets. Direct access to audit trails, coordinated market surveillance, inspection authority, as well as suitability and customer protection regulation, are all necessary to the SEC's ability to effectively regulate and protect investors. Although the SEC actively pursues those who violate the securities laws, much of our success results from *preventing* problems before a single investor is harmed.

The SEC should not be required to seek the permission of any other entity to protect investors. The SEC has many decades of experience and legal precedent in protecting the public – expertise that should be carried over to equity substitutes such as single stock futures. Our securities markets are second to none because of the investor confidence that has flourished under this regulatory framework. It would be extremely unwise to move ahead with legislation that lacks the elements necessary to ensure the market integrity, suitability, and customer protections that investors have come to expect under the securities laws.

Do Not Harm Existing Markets

Fourth, the framework must avoid any harm to existing capital markets. In lifting the ban on single stock futures and reopening jurisdictional issues, legislative changes should not take away existing SEC authority over financial products. For instance, the Shad-Johnson Accord clarified the SEC's jurisdiction over security options, and that jurisdiction should not be diminished in any way. Nor should legislation eliminate the SEC's existing role in evaluating stock indexes for susceptibility to manipulation and compliance with appropriate standards that assure they will not become a surrogate for single stocks. Given the CFTC's exclusive jurisdiction over such futures, the standard put forward in any bill and the SEC's role in applying it must be sufficient to deter insider trading through index futures. Investors have strong expectations about the integrity of markets that the SEC regulates, and the resultant investor confidence fuels the

success of those markets. Accordingly, legislation should not eliminate any existing SEC oversight of securities and related markets.

Moreover, we cannot allow market integrity issues in new markets to migrate to existing capital markets. Because problems in one market, at times, may be identified and understood only by reference to another market, legislation must provide for coordinated surveillance of all markets.

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Adherence to these principles will leave U.S. markets for these products better positioned to compete against their foreign counterparts. When U.S. markets are forced to compete against each other for investors' business and to maintain the integrity that promotes investor confidence and attracts additional business, those markets should be leaders in the international arena. As markets around the world compete for customers and capital, one overriding principle will serve as our competitive advantage: the quality of our markets.

2. Discussion Draft

The Commission staff prepared a discussion draft that incorporates these legislative goals into amendments to the federal securities laws and the Commodity Exchange Act. Unfortunately, given the pendency of this bill as well as bills in the House, the CFTC has not apparently had a chance to review or comment on our draft in detail. In addition to the extension of securities law protections to covered products, much of the proposal is devoted to ensuring that those laws do not unnecessarily burden the markets and intermediaries that trade those products. We continue to look forward to comments from the CFTC and to having a dialogue with your Committees on our suggested approach. We are setting out below a brief summary of the principal elements of that plan – a plan that presumes shared SEC and CFTC jurisdiction over these products.

First, this draft framework defines single and narrow-based stock index futures as securities. This triggers SEC oversight and the application of the securities laws. Then, having brought the markets and intermediaries that trade these products under the securities laws, we next focus on detailed regulatory relief for some of these intermediaries and markets as a means to avoid unnecessary or duplicative regulation.

For example, we exempt from registration those floor brokers on designated contract markets already registered with the CFTC. We also create a simple process of notice registration with the Commission for certain markets and intermediaries already registered with the CFTC. And, such markets and intermediaries would have to comply only with securities law provisions that are considered "core." We clearly exempt these markets and intermediaries from the numerous non-core provisions of the securities laws, where the CEA and CFTC regulation sufficiently addresses the same public policy concerns.

For the core provisions of the securities laws that would still apply to these entities, we provide innovative ways to relieve their regulatory burdens and to coordinate our regulatory efforts with the CFTC. For example, for many of the proposed rule changes that CFTC-regulated markets would submit to the SEC, we provided for immediate effectiveness of such changes and a limited scope of review. Where appropriate, in areas such as examinations, we recognize that the CFTC should be the lead regulator for such CFTC-regulated entities and limit our activities accordingly.

In addition to the detailed regulatory relief and coordination provisions, we provide minimum requirements to be incorporated into listing standards for these products. Such requirements, along with provisions related to coordinated clearing, are aimed at promoting market integrity and intermarket competition.

Finally, we incorporate these products into other relevant securities laws, such as the Securities Act of 1933, the Investment Company Act, and the Investment Advisers Act. In doing so, we avoid unnecessarily burdensome regulation under these acts as well.

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This discussion draft shows that the protections of the securities laws can be extended to single stock and narrow-based stock index futures while still permitting the efficient operation of our markets. Our discussion draft would achieve the goals of creating a new market for single stock and stock index futures that is competitive, fair, and free from fraud and manipulation. U.S. investors deserve nothing less. U.S. capital markets provide the lifeblood of American business and are the place where American families invest their hard-earned dollars with hopes of earning returns that will provide for everything from their children's educations to their retirements. We cannot afford to put these markets at risk.

B. Comparison to S. 2697

Crafting our plan was not easy. Therefore, I appreciate your efforts in drafting the bill. Moreover, I am heartened by the bill's attempt to recognize some of the principles that the Commission feels are so important in this area. Unfortunately, as written, the bill ultimately does not vindicate those principles and achieve the goals of the legislative framework previously outlined. The bill does not sufficiently extend the protections of the securities laws to single stock and narrow-based stock index futures. The Commission therefore could not support the legislation in its current form.

As you continue to revise your legislation, I would hope your bill ultimately can answer questions, such as the following, in the affirmative:

- Does the bill clarify *in both the CEA and the securities laws* that the SEC has full authority over single stock and narrow-based stock index futures and that the securities laws protections apply to these products?

- Does the bill provide for expedited registration of the intermediaries and exchanges that trade these products with both the SEC and the CFTC?
- Does the bill provide real mechanisms for both the SEC and the CFTC to ensure that the relevant securities and futures regulations, such as those related to margin, remain harmonized on an ongoing basis?
- Are there provisions for coordinated clearing of these products?
- Are there provisions that enable the CFTC and SEC to work together to foster competition in the markets for these products?
- Will both the CFTC and SEC be able to effectively prosecute frauds involving these products?

The staff and I look forward to providing additional technical assistance to help you reach the right answers for our markets.

III. Conclusion

Once again, the Commission appreciates the efforts that the Committees have made in bringing derivatives issues to the forefront. We believe the regulatory provisions that we have set forth can support the work of the Committees in their efforts to repeal the ban on single stock futures and eliminate uncertainty for the OTC derivatives markets in a way that fosters competition, bolsters market integrity, and ensures that no harm befalls America's capital markets or investors. Only then can the promise of these products to American investors be fulfilled. And only then will U.S. markets, tested under the rigors of true competition, be ready to vie effectively with foreign markets.

The Commission appreciates the Committees' efforts with respect to derivatives issues. Just as derivatives products themselves can be complex, so too are the issues that surround these products. Having regulated securities derivative products for decades, the Commission welcomes the opportunity to actively participate in the dialogue about derivative products that your bill will engender. We look forward to sharing our views with your Committees, the Working Group, market participants, and other legislators as changes continue to be considered.

Thank you.

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Testimony of

William J. Rainer, Chairman
Commodity Futures Trading Commission

Before the U.S. Senate
Committee on Agriculture, Nutrition and Forestry
And
Committee on Banking, Housing and Urban Affairs

June 21, 2000

Thank you, Chairman Lugar, Chairman Gramm, Senator Harkin, Senator Sarbanes, and members of the Committees. I am pleased to appear on behalf of the Commodity Futures Trading Commission to discuss the important issues addressed in S. 2697.

The Commission commends your efforts to modernize the Commodity Exchange Act and to provide legal certainty for over-the-counter derivatives, remove impediments to innovation, and to reduce systemic risk. In furtherance of those recommendations, the bill encourages the development of electronic trading systems and clearing systems for OTC derivatives.

The bill responds to the President's Working Group's request for urgent legislative action on its recommendations, so that the U.S. may retain its leadership in these rapidly developing markets. Rapid implementation of the Group's proposals is essential to enable U.S. markets to keep pace with the technological and structural changes occurring in markets around the world.

Reform of the Commodity Exchange Act is a critical element of this process. The Commission recognizes the challenges involved in an undertaking of this complexity and appreciates your comprehensive approach to this task, as well as the efforts by both Committees to advance the reauthorization process this year.

The Commission welcomes your proposal to enhance legal certainty for over-the-counter derivatives by excluding from the CEA certain bilateral transactions entered into on a principal-to-principal basis by eligible parties. The market for OTC derivatives has expanded dramatically over the past two decades, as financial institutions rely increasingly on these transactions to manage interest rate and foreign exchange risk, for themselves and for clients in all major sectors of the economy.

These financial markets play an important role in the global economy, and legal certainty is a crucial consideration when parties to OTC derivative contracts decide with whom and where to transact business. The President's Working Group recognized that legal certainty for OTC derivatives is vital to the continued competitiveness of U.S. markets.

The Commission has reservations, however, about the bill's exclusion of OTC energy derivatives from the CEA. On this point, S. 2697 diverges from the recommendations of the President's Working Group, which limited the proposed exclusion to financial derivatives. The Commission believes the distinction drawn by the Working Group between financial and non-financial transactions was a sound one and respectfully urges the Committees to give weight to that distinction.

Most dealers in the swaps market are either financial institutions subject to supervision by bank regulatory agencies, or affiliates of broker-dealers regulated by the SEC, or affiliates of FCMs subject to CFTC oversight. "Accordingly, the activities of most derivatives dealers are already subject to direct or indirect federal oversight." (PWG at 16). The same cannot be said of trading in energy derivatives. The decision to extend the exclusion in S. 2697 to energy derivatives would leave these OTC products in a regulatory gap--neither directly regulated as financial products, nor indirectly regulated by an agency with jurisdiction over commercial participants in the energy market. Thus, a principal argument warranting the exclusion of financial derivatives from the CEA--the fact that derivatives trading in these products is subject to direct or indirect federal oversight--does not apply to OTC energy transactions.

Nor are other arguments supporting the financial derivatives exclusion transferable to energy derivatives. The Working Group's recommended exclusion from the CEA for financial contracts focused on the facts that such contracts are not susceptible to manipulation and do not serve a price discovery function. A consensus exists within the markets and among financial regulators that trading in financial OTC derivatives is not susceptible to manipulation. That case has not been made with respect to energy products.

The unanimous recommendation for an exclusion for financial products resulted from months of deliberation by federal financial regulators. No comparable coordination has occurred between the CFTC and any of the numerous federal entities and programs with jurisdiction over cash markets for energy. An exclusion for trading in energy contracts may create incentives for

existing exchanges to convert to restricted, institutional markets, or more likely, may lead large traders to migrate to unregulated markets. Either event would threaten the important price discovery role played by regulated energy futures trading. A step of this magnitude should be preceded by public discussion.

The CFTC therefore believes that there is insufficient evidence to support the bill's exclusion of energy products. Regulatory relief is more appropriately provided through the Commission's exemptive authority. We have a substantial history of responsiveness in this area. For example, the Commission's staff has issued two no-action letters within the past six months to electronic trading platforms, the sponsors of which include several of the largest participants in the energy markets. The staff required compliance with only those minimal regulatory requirements necessary to assure the platforms' transparency and fairness to members. There are many additional examples of adaptive responses. And, as the Committees are aware, bilateral OTC energy trading between commercials, dealing with each other on a principal-to-principal basis, has been exempted from all but the antimanipulation provisions of the CEA since 1993.

The Commission believes that in developing an effective regulatory scheme, it would be appropriate to review contracts and products on a case-by-case basis, relying on the criteria set forth in our regulatory reform package, which considers risk of manipulation, the degree to which a contract serves a price discovery function, and characteristics of the market participants. As the discussion over the treatment of energy commodities progresses, the Commission will be pleased to continue working with the Chairmen and members of the Committees to find an acceptable resolution of this issue.

* * *

The Commission supports S. 2697's exclusion for electronic trading facilities for OTC financial derivatives to promote an environment in which innovative systems can flourish without undue regulatory constraints. Electronic trading systems have the potential to foster efficiency and transparency and such systems should be permitted to develop unburdened by an anticipatory regulatory structure.

S. 2697 also permits clearing of OTC derivatives and authorizes a mechanism for the CFTC to regulate facilities that clear OTC derivative contracts. Again, the President's Working Group specifically recommended removing legal obstacles to the development of appropriately-regulated clearing systems to reduce systemic risk, and we support this recommendation with the following reservation. The bill would allow securities clearinghouses to clear a broader range of contracts than futures clearinghouses. Futures clearinghouses would have to register in a dual capacity--as futures and as securities clearinghouses--to clear the same mix of contracts available to securities clearinghouses holding a single registration. By declining to grant futures clearinghouses equal opportunity to compete, the bill may put the government in the position of determining winners and losers. We urge the Committees to avoid placing futures clearinghouses at a competitive disadvantage.

The Commission supports the bill's revision of the Treasury Amendment to make clear our jurisdiction over transactions entered into between retail customers and unregulated entities, including so-called "bucket shops." We have long sought legal clarity in this area in order to protect fully the public from foreign currency fraud.

* * *

Section 22 appears to contemplate allowing retail access to derivatives markets. We are continuing to study this aspect of the bill, which has far-reaching implications of uncertain impact. We note that it goes beyond the recommendations of the Working Group, which proceeded on the premise that swaps trading should be limited to market participants with substantial financial resources.

* * *

Earlier this month, the Commission approved for publication in the Federal Register its comprehensive regulatory reform package, which alters fundamentally the Commission's regulation of futures and options markets. This proposal was based on a comprehensive evaluation of the CFTC's current regulatory structure and represents an effort to streamline that structure and to relieve domestic exchanges from unnecessary regulatory requirements. The proposal follows the Congressional directive to transform the Commission from a front-line to an oversight regulator. The Commission looks forward to working with interested parties as we continue to tailor our regulatory reform proposal in a way that most effectively achieves these goals.

S. 2697 attempts to codify much of the Commission's regulatory reform proposal, and we welcome your support of the Commission's initiatives. We have noticed, however, that the bill does not include a provision for derivative transaction facilities restricted to commercial participants. Under the Commission's framework, such commercial facilities may list a contract on any commodity, without regard to the nature of the underlying supply. We believe this

subcategory of trading facility will be useful to diverse commercial markets and urge the Committees to include it. The CFTC staff is undertaking a comparative analysis of our proposed framework, as released on June 8th, and the relevant provisions of the legislation. We will be pleased to submit the results of that review to the Committees in the near future.

* * *

S. 2697 addresses the issue of equity futures contracts and reflects efforts to develop a plan to amend the Shad/Johnson Accord. The Working Group recommended that the CFTC and the SEC work together to determine whether and how the Accord should be amended, and the agencies have worked diligently on this project over the last several months. We agree in principle that equity futures should be available to the marketplace. On March 2, the two agencies presented to Congress our areas of agreement and issues that remained unresolved up to that point, and on May 23, Chairman Levitt and I met with Chairman Lugar and Chairman Gramm to discuss the issue further. The agency staffs have agreed on many specific areas relative to lifting the ban, such as harmonizing margin requirements, restricting dual trading, testing for sales and supervisory personnel, and the establishment of uniform listing standards for single stock futures, among others. We acknowledge, however, a fundamental disagreement concerning the appropriate legislative approach.

The CFTC has sought to avoid creating a framework that potentially could result in over-regulation of markets and intermediaries and therefore advocated identifying those core provisions from each regulatory regime necessary to ensure an appropriate level of oversight for trading these products. While the agencies agreed that duplicative regulation must be avoided, the CFTC staff expressed concern that an "umbrella" approach, meaning the application of the

panoply of securities regulation to these products, could result in overly burdensome regulation. The SEC staff insists that defining equity futures products as securities is essential to its regulatory functions. This fundamental difference in approach has led to an impasse.

With respect to S. 2697, we have no objection to the Shad-Johnson provisions that bear on regulatory issues related to the CFTC's oversight of single stock futures.

* * *

Again, the Commission appreciates the opportunity to present its views. I would be happy to answer any questions you may have.

DOCUMENTS SUBMITTED FOR THE RECORD

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Statement of The Bond Market Association

Before the
United States Senate
Committee on Agriculture, Nutrition and Forestry
and
Committee on Banking, Housing and Urban Affairs

Hearing on S. 2697, The Commodity Futures Modernization Act of 2000
June 21, 2000
Submitted for the Record

The Bond Market Association is pleased to comment on S.2697, the Commodity Futures Modernization Act of 2000. S. 2697 represents an important step in the regulatory reform of the markets for derivative financial products. The bill includes a number of proposals designed to streamline the regulatory environment for derivatives, and clarify several important areas of legal uncertainty which result in undue systemic risk. For these reasons, we commend Chairman Lugar for his introduction of S. 2697 and Chairman Gramm and Senator Fitzgerald for their original cosponsorship, and we support these aspects of the bill.

Reauthorization of the Commodity Exchange Act (CEA) presents an opportunity to clarify the regulation of certain financial products and to eliminate any misconception regarding the scope of authority provided under the CEA. We concur with the widely held belief that swaps are inappropriately regulated as futures, and we believe that the CEA should codify the principle that swaps should not be regulated as futures by the Commodity Futures Trading Commission (CFTC). Such clarification would mitigate legal risk for market participants and would help maintain over-the-counter markets as viable alternatives to traditional, organized exchanges. It would also help avoid duplicative and unnecessary regulation. Congress has the opportunity through the CEA reauthorization to help assure that the capital markets can continue to operate as efficiently as possible.

The Bond Market Association represents securities firms and banks that underwrite, trade and sell fixed-income securities in the U.S. and international markets. Our interests in S.2697 relate to how the bill would affect the efficient operation and regulation of the markets for bonds and other fixed-income securities and related instruments, and our comments will focus on just those aspects of the bill.

The Financial Markets and the CEA

As the two Committees are aware, the financial markets have grown increasingly complex in recent years. Issuers of securities and other market participants have become accustomed to having a wide array of products available to meet very specific financing requirements. Unfortunately, the United States regulatory system has not kept pace with the evolution of the marketplace. Issuers, underwriters and dealers now find themselves laboring to decipher a web of overlapping and often contradictory statutes and regulations that reduce efficiency and increase costs. Of particular concern is the potential for private parties to exploit ambiguities in the CEA to abandon responsibility for otherwise enforceable contracts—even if there is no fraud or bad faith—by alleging that a transaction is an illegal off-exchange futures transaction. We know that these committees, regulators and participants in these markets have an interest in ensuring the finality of financial contracts and thereby reducing potential risks to the financial system as a whole. For this reason, we commend Chairmen Lugar and Gramm for exploring ways to improve and update the Commodity Exchange Act.

The Association takes an active interest in promoting and ensuring safe and efficient bond markets that allow governmental entities and corporations to raise debt capital at the lowest possible cost. Toward that end, the basic policy positions we seek to advance as Congress and the regulatory agencies deal with issues surrounding the CEA are:

- preserving the finality and enforceability of contracts freely negotiated between market participants;
- maintaining the OTC markets as a viable alternative to traditional organized exchanges; and
- avoiding duplicative or unnecessary government regulation in the trading and clearance of debt instruments.

Consistent with the above principles, we offer the following summary of our views on certain issues that are integral to the current discussion of CEA reauthorization. The Association:

- supports provisions of the bill which would reaffirm and clarify the Treasury Amendment and recommends additional changes;
- supports the goals other provisions of S.2697 designed to provide "legal certainty" for over-the-counter derivatives;
- continues to analyze the effects of the bill's treatment of clearing organizations and the repeal of the Shad-Johnson accord on the bond markets; and
- urges the adoption of separate legislation to reduce systemic risk in the financial markets by reforming bankruptcy and insolvency law.

Treasury Amendment

The market for government securities is well regulated under a structure tailored to the unique qualities of the market. Under authority provided by the Government Securities Act of 1986 and subsequent 1993 amendments, the Treasury Department is a principal rulemaker for the government securities market. The Treasury Department, in consultation with other regulators, has published detailed rules regarding large position reporting and record-keeping. The National Association of Securities Dealers and bank regulators have published rules regarding sales practices. The SEC has broad authority to enforce antifraud statutes on government securities market participants. The CFTC and the organized exchanges, of course, regulate activity related to transactions in listed futures contracts on government securities. This balanced arrangement ensures that the government securities market remains safe and well-regulated in addition to serving as a model of market efficiency.

Efficient and sound regulation of the government securities market is important because it helps ensure that taxpayers pay the lowest possible interest cost on the government's borrowing and that other U.S. borrowers whose debt is priced relative to Treasury securities—corporations, financial institutions, homebuyers, consumers and others—also enjoy reasonable borrowing costs. There are approximately $3.1 trillion of marketable Treasury securities outstanding, and over $200 billion of Treasury securities change hands every day. Any undue risk or uncertainty regarding the market's regulatory structure can have significant effects on the government's interest cost and the interest rates faced by other borrowers.

When the CEA was first enacted in 1974, Congress included a provision precluding the CFTC from regulating "transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade." This provision has become known as "the Treasury Amendment." The Treasury Amendment is important because it helps prevent duplicative or conflicting regulation.

The Treasury Amendment does not explicitly address questions regarding the regulation of financial products which involve government securities. These include, for example, instruments such as repurchase agreements, swap contracts and forward delivery contracts. This issue was addressed indirectly by the U.S. Supreme Court in its 1997 decision in *Dunn v. CFTC*, where the Court generally held that "transactions in" foreign currency encompass all transactions relating to foreign currency. Market participants widely believe that the same standard applies to other financial products covered under the Treasury Amendment, including government securities.

S. 2697 would generally maintain the current structure of the Treasury Amendment. The bill would specify that the CEA does not apply to transactions *in* government securities, foreign currency, security warrants, security rights, resales of installment loan contracts,

repurchase transactions in a financial commodity—a particularly important and welcome clarification—or mortgages or mortgage purchase commitments. Futures contracts related to these products traded on an "organized exchange" would still be subject to CFTC regulation under the bill. The bill retains existing statutory language, implying Congress' intent to embrace the Supreme Court's interpretation of such language. However, S. 2697 would not expressly codify the Supreme Court's interpretation of existing law regarding financial products involving the enumerated instruments. We therefore suggest amending to fully clarify the scope of the Treasury Amendment provisions and address any remaining legal uncertainty regarding the scope of the Treasury Amendment's applicability. In particular, we suggest adding language to Section 4 of the bill specifying that the Treasury amendment exclusions apply to transactions "in or in any way involving" the specified instruments.

Organized Exchanges

S. 2697 would also clarify the applicability of the Treasury Amendment by specifying an exception to the general exclusion for contracts traded on an "organized exchange." Current law provides an exception to the Treasury Amendment for contracts traded on a "board of trade." The definition of "board of trade" is somewhat vague with respect to both evolving electronic trading systems and the roles of certain traditional market participants such as inter-dealer brokers. If "board of trade" was defined under current law to include electronic trading facilities or situations where market participants conduct transactions in a screen-based format and settle them through an independent clearing mechanism, significant market disruption would result. In particular, such a definition would subject already regulated markets to a duplicative layer of government regulation.

Although we support the basic outlines of the new statutorily defined term, the definition in the bill of "organized exchange," with its use of the term "*bona fide*," is vague with respect to certain trades which are conducted on a principal basis. In the fixed-income markets, it is not uncommon for a dealer to buy or sell securities in a "back-to-back" transaction with an investor—who may or may not be an "eligible contract participant"—on one side and another dealer or investor on the other. Clarification of this issue is extremely important to the bond markets because it goes to the heart of achieving legal certainty. We feel strongly that Congress should clarify, consistent with the bill's intent, that whenever an intermediary retains credit or execution risk in connection with a back-to-back transaction, it is acting as principal and not on behalf of any third party. This is true even if the credit or execution risk is mutualized through the auspices of a regulated clearing organization.

Legal Certainty for OTC Derivatives

Under current law, the CEA effectively gives a party the right to rescind a contract if the party is successful in alleging that the transaction was actually an illegal, off-exchange futures contract. Under the CEA, over-the-counter commodity futures transactions are *per se* illegal unless they are excluded by the Treasury Amendment or some other exemption. Private parties have taken the position that such transactions are subject to

rescission. This harsh consequence of voiding a contract is particularly troublesome in light of the difficult questions associated with defining a future versus a forward transaction. We believe the financial markets should not be subject to the risks posed by the ability to abandon contract obligations when the CEA status of a financial transaction is challenged. S. 2697 includes two key provisions designed to address this problem.

First, the bill would specify that the CEA does not apply to over-the-counter derivative contracts entered into between "eligible contract participants" which are not conducted on a "trading facility" other than an "electronic trading facility." Second, the bill would specify that financial contracts may not be rescinded "solely on the failure of the agreement, contract, or transaction to comply with the terms or conditions of an exemption or exclusion from any provision of this Act or regulations of the Commission." Together, these two provisions represent a major step towards addressing the question of the "legal certainty" of over-the-counter derivative contracts, a goal which we fully support.

Other Provisions of S. 2697

In addition to the provisions cited above, The Bond Market Association offers these comments on other provisions of S. 2697:

- Shad-Johnson accord—Although presumably intended to permit single-stock futures, the bill expressly would allow futures on "non-exempt securities," thereby permitting futures on single debt instruments. This would raise novel questions which until now have not been thoroughly analyzed. We are currently exploring these issues, and look forward to providing additional detail. If the intention of the subcommittee is to permit only single-stock futures, we suggest amending the bill's language to make that explicit.

- Clearing organizations—We are analyzing the potential effects of the bill on clearing organizations, and we look forward to providing additional input.

- Bankruptcy—Although not part of S. 2697, the report of the President's Working Group on the Financial Markets on financial derivatives recommended the adoption of changes to the Bankruptcy Code and banking law designed to reduce systemic risk. The Working Group's recommendations would streamline the process by which financial contracts can be netted and resolved in cases of bankruptcy or insolvency. Legislation is pending in both the House and Senate to adopt these recommendations, and we are very supportive of these efforts.

Summary

In recent years, we have seen a rapid acceleration in the development of new and sophisticated financial products designed to mitigate risk, reduce costs and enhance efficiency. Unfortunately, the evolution of our regulatory structure for financial derivatives has lagged behind the evolution of the markets themselves. It is appropriate,

therefore, for Congress to address the uncertainty and risk which has arisen as a result of a system of regulation which never anticipated the market we have today.

The Bond Market Association supports provisions in S. 2697 designed to enhance and clarify the Treasury Amendment. We also recommend additional changes to the Treasury Amendment to clarify the treatment of products involving exempt instruments and to clarify the application of the "organized exchange" provision. We also support the goal of key provisions of the bill to provide legal certainty with respect to the regulation of over-the-counter derivatives. We are continuing to examine the implications of the Shad-Johnson repeal and the bill's treatment of clearing organizations on the bond markets, and we look forward to providing additional analysis and input. Finally, we urge the adoption of bankruptcy and insolvency legislation designed to reduce systemic risk in the financial markets.

We appreciate the opportunity to present our views on S. 2697. We commend Chairmen Lugar and Gramm and other members of the Agriculture and Banking Committees for their quick action on these important issues, and we look forward to working with subcommittee members and staff as the legislative process moves forward.