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The Honorable Christopher J. Dodd
Chairman
Securities Subcommittee
Committee on Banking, Housing,
and Urban Affairs
U.S. Senate
Washington, D.C. 20510-6078

Dear Senator Dodd:

Before undertaking to reply to your letter of March 28, 1991, we at Merrill Lynch would like to express to you and to Senator Heinz's other colleagues in the Senate our deep regret and sympathy at his tragic and untimely passing, and our appreciation for his interest in the issues affecting our industry.

Merrill Lynch appreciates the opportunity to comment on Title III of The Futures Trading Practices Act (S. 207) as reported by the Senate Committee on Agriculture, Forestry and Nutrition. Merrill Lynch has serious concerns that S. 207 in its present form will have adverse consequences on the U.S. markets for hybrid securities and swap transactions which could inhibit the orderly development of these markets without a commensurate gain in investor protection or systemic stability. Representatives of Merrill Lynch met with Commodity Futures Trading Commission (CFTC) Chairman Gramm to express our reservations regarding the swap provisions; we have also been part of an industry group working with the CFTC to arrive at acceptable statutory language regarding swap transactions.

The Swap Market

The global market for interest rate, currency, commodity and other index-linked swap transactions is today a massive one. Industry statistics suggest that in excess of $3 trillion of interest rate and currency swaps alone are currently outstanding. These instruments are used by U.S. government agencies and government sponsored entities, supranational entities, foreign sovereigns, municipalities, corporations and financial institutions to manage interest rate, currency, commodity and other price or rate risk, and as an integral element of financing and funding transactions. Indeed, it is estimated that in 1990 as much as 15% of underwritten corporate debt financings in the United States were linked to, and made possible by, related swap transactions. Accordingly, swap transactions are a vital risk management and hedging tool and a fundamental component of domestic and international capital markets.

Two important, and interrelated, characteristics of the swap market are particularly relevant in the discussion of the impact of S. 207 as it presently stands. The explosive growth of the market over the last several years has been fueled by the flexibility of the products and the ingenuity of market participants in designing such products to meet the needs of customers. Rapid innovation and an ability to respond to changes in the marketplace and in customer needs have been hallmarks of the development of the market. Thus, Merrill Lynch was particularly comfortable with the “individual negotiation” standard contained in the original version of the bill (directing the CFTC to exempt individually negotiated swaps undertaken in connection with a line of business or hedging activities).

The “customized” quality of swap market transactions distinguishes the swap market from futures markets. Since the transactions involve counterparty-to-counterparty credit risks, the market is characterized by careful evaluation of counterparty credit and, where necessary, use of collateral or other forms of credit support. Because of the generally high credit quality of participants in the market, and the prudential employment of collateral and credit support, the incidence of default has been low. In fact, from the inception of its swap business in the late 1970’s to date, Merrill Lynch has yet to experience a loss as a result of a counterparty default on a swap transaction. Thus, we believe that one of the principal purposes of an amendment to the Commodity Exchange Act (CEA) regarding swaps is not to redress any perceived inadequacy of regulation in the market, but rather to provide certainty regarding the legal status of swap transactions in the United States.

As the swap market has grown, a variety of efforts to reduce any potential credit risks and counterparty exposure, particularly among the dealer community, have been undertaken. Amendments to the U.S. Bankruptcy Code, and similar provisions in FIRREA, were adopted last year, clarifying the rights of parties upon the bankruptcy or insolvency of a counterparty to a swap transaction. Bilateral risk mitigation techniques are actively being employed or developed, and multilateral techniques are under consideration. The flexibility and innovation which distinguish the swap market are also evident in these developments.

Existing Provisions of S. 207 with Regard to Swaps

The purposes of any amendment to the CEA relating to swaps should be to provide certainty to market participants regarding the legal status of swap transactions in the United States, as well as to protect and enhance the innovative techniques employed in the swap market to hedge risk and provide financing, and to mitigate counterparty risk resulting from a large and growing market.

These purposes are best achieved by exclusion of swap transactions meeting explicit and objective standards from the provisions of the CEA. S. 207 as it currently stands does not provide such an exclusion.

On the contrary, the exemptive authority granted to the CFTC in S. 207 would, we believe:

- enable the CFTC to exempt qualifying swap transactions from some, but not all, of the prohibitions and requirements of the CEA;
- authorize the establishment of financial or other requirements for the enumerated "institutional participants" in exempted swap transactions;
- leave unclear what role the creditworthiness of a party must play in qualifying swap transactions; and
- create vague limitations on the development of "trading markets" in swap agreements.

The legal uncertainties and restrictions on innovation resulting from these provisions are likely to have a chilling effect on the continued development of the market in the United States. Legal uncertainties under current law have already driven some swap business offshore. Failure to address these uncertainties could result in the limitation on the availability of swap products in the United States, without a similar restriction in offshore markets, reducing the competitiveness of U.S. markets and the financial stability of users of these instruments in the United States.

<u>Recent Developments with Regard to Swaps</u>

We continue to believe that an exclusion from the provisions of the CEA for swap transactions meeting objective standards which foster market-driven innovation in risk mitigation is the preferred method of meeting the goals outlined above. We have joined with representatives of a large number of U.S. participants in the swap market to discuss with the CFTC and other regulators ways of addressing our concerns regarding the uncertainties and strictures in S. 207 as reported. Substantial progress has been made in developing language which would address many of these concerns and we appreciate the responsiveness of the CFTC and its staff to the concerns raised in these discussions.

<u>Hybrid Instruments</u>

Merrill Lynch has been integrally involved in the developing market for hybrid instruments, including products indexed to physical commodities, indices and currencies. The ability of issuers and underwriters to develop new types of financial instruments, however, has been affected by the restrictions imposed under the CEA, as interpreted and applied by the CFTC. As a result, issuers have been prevented from exploring alternative means of financing their business operations in an increasingly competitive market environment, and investors have been prevented from taking advantage of valid investment opportunities. Accordingly, we believe that the CEA should be amended to provide greater certainty and flexibility to issuers and underwriters seeking to introduce new types of financial instruments.

To date, the CFTC has promulgated certain rules and interpretations concerning hybrid instruments which have facilitated their development by providing some degree of guidance to issuers and underwriters of these products. We recognize that certain of these products, if they in fact constitute futures contracts and commodity options rather than simply containing elements of such instruments, could implicate the customer protection and market integrity objectives of the CEA, and therefore, we understand the regulatory concern that such products not be marketed to members of the general public without the necessary safeguards against potential abuses.

Nevertheless, we believe that simpler and more objective tests can and should be adopted to provide a greater degree of certainty to issuers and underwriters. The development of innovative hybrid products historically has been a function of the evolving needs of market participants. Such innovation should not be discouraged on the basis of unnecessary legal uncertainties, particularly if our capital markets are to remain competitive with others worldwide. Consequently, in seeking the appropriate balance between the need to encourage flexibility and innovation in the capital markets and the purposes of the CEA and the CFTC's statutory mandate, consideration should be given to existing statutory frameworks which may also be applicable to the issuance of these products, such as the disclosure and investor protection provisions of the federal securities laws and the banking regulatory framework.

In our view, the hybrid instrument provisions of S. 207 represent substantial progress toward reconciling these competing interests and implementing a workable and effective approach to the regulation of these products. The creation of a "bright line" test, which seeks to determine whether an instrument is predominantly a futures contract or commodity option, should provide greater certainty to the marketplace than the existing CFTC precedents, which condition the availability of relief on complex formulas and computations. In addition, the adoption of a statutory exclusion for products which are not predominantly futures or commodity options would allow issuers and underwriters to avoid the substantial expense and delay associated with obtaining relief from the CFTC on a case-by-case basis.

Our one remaining concern rests with those products that do not meet the statutory "bright line" test and thus, under S. 207, would be prohibited, since they would be outside the scope of the exclusion. In certain instances, we can envision that products might be developed that would serve valid portfolio or risk management purposes, and we would suggest, at a minimum, that the CFTC be given the authority to grant exemptions from the CEA, either unconditionally or on specified terms and conditions.

We also believe that, where such instruments have significant characteristics of a security, their failure to be excluded from the CEA should not necessarily result in the complete prohibition of the product. We note that the SEC and others have suggested that, in certain instances, such instruments might properly be regulated and traded as securities. Certainly, where Congress or the SEC is comfortable that the federal securities laws are adequate, both in terms of disclosure and customer protection, then it may be appropriate to permit such a product to be regulated as a security and traded in the securities markets. At a minimum, serious consideration should be given to the proposals of this kind that have been articulated to date.

Again, we appreciate the opportunity to discuss our views on this topic so important to the operations of the U.S. capital markets.

Sincerely,

Bruce Thompson, Jr.