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Mr. Chairman, members of the Committee. Thank you for the opportunity to appear before you today to discuss bank derivative activities. The subject of over-the-counter (OTC) derivative markets has engendered a great deal of discussion and led to several recent studies. This discussion is fueled by reports that the OTC derivative market has grown rapidly to a size of over $5 trillion in notional principal. The Commodity Futures Trading Commission believes this dramatic growth presents a number of important policy issues. The Commission is pleased to have this opportunity to present its views on this topic.

As you know, the CFTC regulates the futures and options on futures markets in the United States. These markets have been, and continue to be, one of America's most innovative and competitive industries. The United States has the oldest and largest futures markets in the world; our markets have always been the world leader in financial innovation. United States futures markets permit commercial institutions, firms, institutional investors, and fund managers to manage risk associated with changing cash market prices. In 1960, 3.9 million futures contracts were traded. Last year, over 364.5 million contracts traded. Today, United States futures markets serve as models for other countries developing futures and option products, just as the regulatory system at the

CFTC serves as the model for other countries developing futures market regulatory systems.

Commission regulated markets are, of course, only one part of the overall derivatives market place. OTC derivatives currently trade for the most part outside the CFTC's regulatory structure. Concerns about the adequacy of regulatory controls over OTC derivatives prompted Congress to direct the Commission to conduct a study of OTC derivatives markets to determine the need, if any, for additional regulation of these markets. Pursuant to this directive, the Commission prepared a report entitled OTC Derivative Markets and Their Regulation which was transmitted to Congress on October 25, 1993. The findings of this report are discussed below. In addition, we provide answers to each of the questions posed in Chairman Gonzalez' letter of October 6, 1993.

Question 1. Please summarize your agency's strategy for supervising derivative market activities.

The Commodity Exchange Act (the "CEA" or "Act") vests the Commodity Futures Trading Commission ("CFTC" or "Commission") with exclusive jurisdiction over futures and commodity option transactions.[1] The CFTC regulatory framework for such transactions is essentially directed toward oversight of exchange trading of futures and options contracts and of intermediaries engaging in

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1/Section 2(a)(1)(A)(i) of the CEA grants the CFTC exclusive jurisdiction with respect to "accounts, agreements (including any transaction which is of the character of . . . an "option" . . .), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market . . . or any other board of trade, exchange or market . . ."

such transactions on behalf of customers. Subject to certain narrowly defined exceptions and to the CFTC's recently enacted authority to exempt certain transactions or categories of transactions from most provisions of the CEA, all transactions in commodity futures contracts and all commodity option transactions are required to occur on or subject to the rules of contract markets (exchanges) designated by the CFTC. These markets provide safeguards to participants in futures and commodity option transactions such as open and competitive trading, continuous markets, public price dissemination, and protection against counterparty risk. Such safeguards are not generally available other than on exchange markets. For example, the financial integrity of futures transactions and commodity option transactions on designated futures exchanges is supported by the system of daily payment and collection of margin on a mark-to-market basis, by minimum capital, segregation and reporting requirements applicable to futures commission merchants ("FCMs"), and ultimately by the obligation of the clearing organization affiliated with each exchange to guarantee the integrity of each transaction entered into on that exchange.

Section 2(a)(1)(B) of the CEA and related securities laws allocate jurisdiction with respect to certain derivative products between the CFTC and the SEC. The SEC has authority to regulate the trading of options on securities, on groups and indices of securities, on certificates of deposit and on foreign currencies when entered into on a national securities exchange. The CFTC has

exclusive jurisdiction over futures trading on "exempted securities," on groups or indices of securities and options on such futures, and over foreign currency options not traded on a national securities exchange.[2] Futures on individual securities other than exempted securities are prohibited.

Although the CEA regulatory framework generally contemplates that futures and commodity options transactions will take place on CFTC-regulated exchanges,[3] CFTC rules have long made certain types of commodity options transactions exempt from most CEA regulatory provisions and the CFTC has, in recent years, specified by statutory interpretation several categories of futures or commodity option-related instruments as excluded from or exempt from the general regulatory scheme.

Trade options, for example, are exempt from most CFTC regulatory requirements. Trade options are off-exchange commodity options offered and sold to commercial counterparties which are entering into the transactions for purposes related to their business. Rule 32.4(a) permits the sale of these off-exchange commodity options, other than options on domestic agricultural commodities, in circumstances in which the offeror "has a reasonable basis to believe that the option is offered to a producer, processor or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option

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2/Section 4c(f) of the CEA provides that the CEA is inapplicable "to any transaction in an option on foreign currency traded on a national securities exchange." 7 U.S.C. § 6c(f).

3/ 7 U.S.C. §6(a).

transaction and that such commercial party is offered or enters into the transaction solely for purposes related to its business as such."

The Futures Trading Practices Act of 1992 (FTPA), which was signed into law on October 28, 1992, accorded the Commission authority to exempt from CEA requirements, including exchange trading requirements, specific transactions or categories of transactions between appropriate persons. New Section 4(c)(1) authorizes the Commission, by rule, regulation, or order, to exempt any agreement, contract or transaction, or class thereof, from the exchange-trading requirement of Section 4(a) or any other requirement of the CEA, other than Section 2(a)(1)(B). New Section 4(c)(2) provides that the Commission may not grant an exemption from the exchange-trading requirement of the CEA unless, inter alia, the agreement, contract, or transaction will be entered into solely between certain "appropriate persons,"[4] and the Commission determines that the agreement, contract or transaction in question will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act. The Commission has thus far

4/ "Appropriate persons" under new Section 4(c)(3) include banks and trust companies, as well as certain investment companies, commodity pools, employee benefit plans, governmental entities, broker-dealers, FCMs, business entities meeting certain minimum asset or net worth tests, and "[s]uch other persons that the Commission determines to be appropriate in light of their financial or their qualifications, or the applicability of appropriate regulatory protections." 7 U.S.C. § 6(c)(3).

used its statutory exemptive authority in connection with swaps,[5] hybrids[6] and certain energy contracts.[7]

In addition, two petitions by commodity exchanges for relief under Section 4(c) are currently pending before the Commission.[8] One is a petition from the Chicago Mercantile Exchange (CME) concerning the purchase and sale of certain of its now exchange-traded Rolling Spot futures and options contracts. The other is a petition from the Chicago Board of Trade (CBOT) seeking exemption for a "professional trading market" in any instrument of any board of trade. The comment period on these petitions closes on December 15, 1993.

Except in the limited circumstances described above, the CFTC regulates products, the markets on which they are required to trade, and certain market participants, including the intermediaries who carry positions in such markets for or on behalf of customers, certain end-users such as large traders, commingled offerings, known as commodity pools, and those who render trading advice. In general, the purpose of the CFTC's regulation is two-pronged: to protect the market and to protect customers. The CFTC regulatory structure is a comprehensive framework for transactions on exchange markets. The Commission's system contemplates both

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5/ 17 C.F.R. Part 35; See also Statement of Policy, 54 Fed. Reg. 30,694 (July 21, 1989).

6/ 17 C.F.R. Part 34; See also Statutory Interpretation Concerning Certain Hybrid Instruments, 55 Fed. Reg. 13,582 (April 11, 1990).

7/ 58 Fed. Reg. 21,286 (April 20, 1993).

8/ See 58 Fed. Reg. 43,414 (August 16, 1993).

direct surveillance and intervention and oversight of exchanges which are required by statute to enforce their rules and certain Commission rules.

Market Efficiency Regulation

The CEA and Commission rules specify certain core duties that exchanges must perform to become and remain designated as contract markets for transactions in futures contracts, including providing for the prevention of manipulation of prices and cornering of any commodity, market and trade practice surveillance, the making of reports and records of transactions effected on or subject to the rules of the exchange, enforcement of exchange rules, and maintenance of procedures for arbitration of customer grievances. The Commission reviews the rules of organizations seeking to establish markets for futures trading and the terms and conditions of the contract traded thereon. This process is intended to assure fair access to the marketplace and that the design of products does not render them readily manipulable.

Product Design. The CEA contemplates that products to be traded on contract markets will be reviewed by the Commission. In general, the Commission has found that products must be used for a risk shifting or price discovery purpose on more than an occasional basis to meet the statutory requirement that proposed futures transactions not be contrary to the public interest.[9] Although not expressly required by the CEA, all exchange-traded futures contracts are fungible, standardized interests, such that all

9/ 7 U.S.C. § 7(g).

contracts for the same commodity and delivery month can be readily netted through the clearing mechanism.

Fraud. CEA Section 4b prohibits any exchange member or agent thereof or any other person in connection with any order to make, or the making of, a contract of sale of a commodity for future delivery for or on behalf of any other person from engaging in various types of fraudulent conduct, including, cheating such other person, attempting to deceive such other person regarding the disposition or execution of an order, or "bucketing" of an order.

Fictitious Trading. The CEA proscribes certain activities which may distort price, appearance of depth and liquidity or positions. For example, wash trades, fictitious trades and prearranged trades are precluded. The CEA also prohibits trading which would cause the market to reflect a price that is not "true and bona fide."[10]

Market and Trade Practice Surveillance. Exchanges are required to maintain continuing affirmative action programs to secure compliance with the CEA and exchange rules. Such programs must include surveillance of market activity for indications of possible congestion or other market situations conducive to

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10/This prohibition is found in § 4c(a) of the CEA, 7 U.S.C. § 6c(a). However, nothing in that section "shall be construed to prevent the exchange of futures in connection with cash commodity transactions or of futures for cash commodities or of transfer trades or office trades if made in accordance with board of trade rules applying to such transactions and such rules shall have been approved by the Commission." Thus, off-floor negotiated transactions known as exchanges of futures for physicals may be permissible. Id. Such transactions, which may establish, liquidate or transfer futures positions, must be reported to the exchange for clearing.

possible price distortion and procedures which result in the taking of prompt, effective disciplinary action for any violation. As part of its routine rule enforcement reviews of the exchanges, the CFTC reviews the SRO market surveillance programs. The Commission also conducts direct surveillance of the markets using required position reports from large traders and has either established its own or approved exchange-required speculative position limits or position accountability limits to prevent market distortions and to protect the delivery process. Exchange rule enforcement programs must include, among other things, trade practice surveillance and effective disciplinary action for violations.

Market Disruption Programs (Circuit Breakers/Emergencies). The CFTC consistent with the provisions of Section 8a(9) of the CEA, can take emergency action when it finds that there is a threatened or actual manipulation or corner or "other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand . . . ." Separately, as noted above, exchanges must have market surveillance programs to detect potential disturbances or price distortions and must take remedial action, including emergency actions in appropriate cases. All commodity exchanges trading securities derivative products have adopted coordinated circuit breaker rules which are designed to become effective when stock indices fall by specified amounts. Pursuant to statutory directive in the FTPA, the CFTC has amended Rule 1.41 to establish new procedures to review contract market emergency actions, including a requirement that an exchange make

every effort practicable to notify the Commission of its intention to implement, modify or terminate an emergency rule.

Price/Volume Dissemination (Transparency). Part 16 of the CFTC rules requires contract markets to publish each day information on the trading volume, open contracts, and prices of futures and options. The information is to be made readily available to the news media and the general public. The price change register must report prices at least every 10 seconds.

Financial Safety Regulation.

Clearing. Clearing organizations have been held to be an essential part of a contract market.[11] Thus each exchange must have a clearing organization and that clearing organization is subject to CFTC oversight. Clearing organization rules are submitted to the Commission for review and, in certain circumstances, for approval pursuant to Commission Rule 1.41. Under CFTC rules, exchanges' clearing houses accept contracts for clearance only for the accounts of their members and guarantee the payment of variation margin to clearing members with net gains on positions in their accounts at the clearing house.

The clearing process for futures contracts effects multilateral netting by novation. Following the execution of a futures contract on the exchange, the contract is presented for clearance to the clearing organization by a clearing organization member. In the clearing process, the clearing organization is substituted for

11/See Board of Trade Clearing Corp. v. United States, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,534 (D.D.C. 1978), aff'd, No. 78-1263 (D.C. Cir. 1979) (unreported).

the original parties to the contract, becoming the buyer to every seller and the seller to every buyer. As the substituted "universal counterparty" to every cleared contract, the clearing organization guarantees performance of each cleared contract. The variation margin representing losses required to be paid to the clearing organization by clearing firms holding losing positions is paid by the clearing organization as variation gains to clearing firms holding opposite positions. The clearing organization guarantee becomes operant if a clearing member firm is unable to satisfy demands for variation margin, representing losses on open positions. In the event of a default by a clearing firm holding a losing position, the clearing organization assures payment to firms holding positions on which profits are owed.[12] The clearing organization guarantee function is secured by original margin deposits required for each cleared contract as well as guarantee funds or other sources.

Margin. As indicated above, clearing organizations collect "original" and "variation" margin from their members. The collection of variation margin is intended to eliminate the credit risk from the market on a daily, or more frequent, basis and to facilitate transactions among anonymous counterparties. Absent an emergency, original margin levels for futures contracts are generally set by exchanges without CFTC review. Recently, however,

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12/See generally Andrea Corcoran and Susan Ervin, Maintenance of Market Strategies in Futures Broker Insolvencies: Futures Position Transfers from Troubled Firms, 44 Washington and Lee L. Rev. 849 (1987).

the FTPA granted oversight authority to the Board of Governors of the Federal Reserve System ("FRB") with respect to levels of margin over stock index futures contracts or options thereon. The FRB has delegated this authority to the CFTC. The CFTC also reviews the methodology for calculation of option margin levels set by the exchanges.

The CME's Standard Portfolio Analysis of Risk ("SPAN") system is used by most, if not all, U.S. futures exchanges. SPAN is a computer program that calculates margin using a portfolio evaluation model that projects the risks of various moves in price and volatility levels on option and futures positions. It develops a combined maintenance margin level based upon the aggregate risk of the combined positions.

Clearing Member Capital. The CFTC has no requirements for clearing members as such. Most clearing houses, however, require their members to maintain a minimum level of capital in order to ensure that clearing members will be able to meet their obligations to the clearing house and to their customers. Most clearing houses also require their members to make substantial deposits to a clearing house guarantee fund to cover any default by a clearing member.

Financial Compliance Programs. Each futures exchange, as a self-regulatory organization ("SRO"), must adopt and enforce minimum financial requirements and reporting rules for its member FCMs that are at least as stringent as those established by Commission regulations. Commission capital rules generally apply

only to firms carrying customer funds. Members transacting solely for their own accounts will ordinarily be subject to exchange and/or clearing organization rules only. As SROs, the futures exchanges and the National Futures Association ("NFA"), an industry-wide SRO responsible for exchange nonmember firms, have the primary direct responsibility to ensure the financial integrity of their member firms. The Commission is responsible for oversight of the SROs' financial surveillance and rule enforcement programs, and for direct auditing of FCMs and IBs that are not members of any SRO. Rule 1.52(c) allows an SRO to delegate audit and financial surveillance responsibility to a DSRO for any member-FCM which is a member of more than one SRO. An FCM's DSRO must monitor and audit compliance with the minimum financial and related reporting requirements for that FCM and receive from the FCM the financial reports specified by the minimum financial and related reporting requirements. FCMs are required to submit quarterly unaudited and annual audited financial reports. Generally an SRO must conduct full scope audits of FCMs for which it is the DSRO once every two years and a limited scope recordkeeping examination during the year in which a full scope examination is not conducted.

Price Limits. In general, each exchange determines the price limits for a particular contract traded at that exchange. Price limits, in volatile markets, create a time-out to permit the collection of variation margin and assessment of financial capacity. In most contracts, the limits do not apply in the "spot" month, during which the contract becomes deliverable.

Market Fairness Regulation

Organized marketplaces generally have rules to assure fairness. In addition to the market efficiency measures discussed above, the Commission regulates exchange governance, order execution and recordkeeping.

Authorization, Qualification and Good Standing (Probity/Competency) Requirements. Commission rule 1.64, adopted June 29, 1993, requires SROs to adopt rules establishing composition requirements for their governing boards and major disciplinary committees. The rulemaking also prohibits persons with certain disciplinary histories from serving on any SRO oversight panel. These requirements take account of the fact that exchanges are membership organizations that maintain public marketplaces and are intended to assure representational diversity on governance boards, foster integrity and impartiality in decision-making, and to prevent preferential treatment in disciplinary proceedings.

Order Execution (Competitive Execution/Dual Trading/Insider Trading). Generally all futures and option contracts which are subject to the rules of an exchange must be executed openly and competitively by open outcry or other methods, such as posting of bids and offers, which are open and competitive. The FTPA directs the CFTC to prohibit "dual trading" by floor brokers in futures or option contract markets with average daily trading volume of 8,000 contracts or more that have not been exempted. On July 22, 1993, the CFTC adopted final rules implementing this statutory directive. On October 19, 1993, the CFTC adopted final rules pursuant to

another statutory directive in the FTPA which prohibit any SRO employee, any member of a SRO governing board, or any member of any committee of an SRO, intentionally or with reckless disregard, from trading commodity interests based on material, nonpublic information obtained through his or her duties at the SRO and from disclosing such information for a purpose inconsistent with the person's official duties. The rules also prohibit any person from trading, intentionally or with reckless disregard, commodity interests for his own account on the basis of material, non-public information that individual knew was obtained from an employee, member of the governing board, or member of any committee of an SRO in violation of the rules' prohibition on disclosing such information.

Audit Trail/Price & Volume Records. The purpose of an audit trail is to prevent abuse of customer orders and improper trade practices by permitting reconstruction of trading and detection of suspicious patterns. An exchange cannot be designated as a contract market until the governing board of the exchange provides for the making and filing of reports showing the details and terms of all transactions entered into on the exchange. The CEA requires that clearing houses and contract markets maintain daily trading records. Rule 1.35 prescribes the scope of recordkeeping for FCMs, IBs, members of exchanges and exchanges for all cash commodity, futures and option transactions.

Customer Dispute Resolution. Each exchange is required by the CEA to provide a procedure, such as arbitration, for the settlement

of customer claims or grievances against exchange members and their employees. The CEA and Rule 170.8 similarly mandate the availability of an arbitration program for customer disputes through the NFA. NFA's program must be consistent with the provisions of Part 180 of the rules, which establish the standards for arbitration programs of the exchanges. A pre-dispute arbitration agreement is generally prohibited by Rule 180.3(b) unless it is in writing and contains specified warnings. The pre-dispute agreement must be specifically endorsed by the customer and may not be a precondition to the customer obtaining the firm's services. The Act also provides for a CFTC reparations procedure in which actions may be brought by customers against a CFTC registrant for violations of the CEA or any rule, regulation or order thereunder[13] and an express private right of action for violations of the CEA.[14]

Regulation of Intermediaries

The Commission regulates futures industry intermediaries, FCMs and IBs, as discussed below. Additionally, the FTPA authorized the Commission to promulgate "risk assessment" rules which will require FCMs to provide reports to the Commission regarding the activities of their affiliates that are reasonably likely to affect the financial or operational conditions of the FCMs themselves. The risk assessment rules will permit better assessment of material risks with respect to the financial

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13/ 7 U.S.C. § 18; see 7 C.F.R. Part 12.

14/ 7 U.S.C. § 22.

condition of FCMs resulting from activities of their affiliates and may help the Commission to avoid or to better manage market disruptions. The Commission has set the development of the risk assessment rules as a priority. Commission staff have been consulting with SEC staff on this project to formulate a coordinated approach that will avoid duplicative reporting. Commission staff will consult other financial regulators as this project progresses.

Financial Safety Regulation

Capital. The CFTC prescribes the minimum financial requirements FCMs and IBs must satisfy to engage in futures business and how those requirements must be calculated. The CFTC generally uses the same capital adjustments as the SEC, including counting only liquid assets in the computation of net capital. In the case of a firm which is qualified as both an FCM and a broker-dealer, the higher of the two agencies' requirements applies. This means that unsecured credit risk is carried at a 100% charge against capital. As a consequence, it is very costly for a regulated FCM to engage OTC derivative transactions and FCMs which do so generally use an unregulated affiliate.[15] Rule 1.52

15/Currently, Commission rule 1.17 requires that certain "haircuts" must be taken in computing net capital for securities options. The Commission is proposing to extend the treatment contemplated by that provision to over-the-counter options on foreign currencies, as well as security indices and options on government debt. 58 Fed. Reg. 43089 (August 13, (1993). Rule 1.17(c)(5)(x) prescribes haircuts for proprietary uncovered futures and options positions. Generally this would be 100% of the applicable margin requirement of the applicable clearing organization if the position is cleared by a clearing organization of which the firm is a member.

requires each SRO to adopt and enforce rules prescribing minimum financial and related reporting requirements for all its FCM members. The NFA is also obligated to adopt such rules for its IB members. The financial and related requirements adopted by the SROs must be equal to, or more stringent than, the CFTC's minimum levels. CFTC rule 1.12 establishes an "early warning system" under which firms are required to notify the CFTC of certain adverse changes in the firm's financial condition in order to permit the CFTC to address a financial situation before it results in market disruption or customer loss.[16]

Margin. The CFTC does not have any regulations restricting collateral or setting levels of margin. However, an FCM cannot represent that it will not call for or collect margin. Also, omnibus accounts must be margined on a gross basis, and firms are required to take a capital charge with respect to customer accounts which remain undermargined for three consecutive days or in deficit for one day. Further, daily marking-to-market of customer futures

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16/The Commission requires an FCM to calculate its minimum adjusted net capital requirement by multiplying the amount it is required to segregate and set aside in special accounts by 4%. The minimum adjusted net capital requirement for FCMs is intended to ensure that an FCM can maintain ongoing operations and financial viability in periods of unusual market stress so that it can continue to meet obligations to customers and the marketplace. Adverse movements in the prices of positions carried by an FCM can cause debits or deficits in customer accounts and if a customer defaults on its obligation to cover the amount owed, the FCM must use its own funds to cover the shortfall since it cannot use one customer's funds to pay for another customer's obligations. The adjusted net capital requirement is intended to provide a cushion for these market and credit risks and to provide time for a firm which has a defaulting customer to transfer other accounts and liquidate the account of the defaulting customer in an orderly manner.

positions is effectively required by Commission rules which require that FCMs compute their segregated funds requirement on a daily basis.

Customer Funds Protection. The CEA and Commission rules require an FCM and clearing organization to separately account for customer funds deposited to margin, guarantee or secure futures positions and the accruals thereon on their books and records, and 100% of such customer funds must be segregated from the carrying firm's own funds.[17] Such funds must be treated as belonging to the customer. In contrast, broker-dealers are required to deposit funds in a bank for the net credit balance owned customers. However, an FCM may pool all customer funds in a single account which must be clearly identified as belonging to customers. An FCM must always have in segregation, free from claims, sufficient funds to meet all its obligations to customers based on the equities in the account, as if such accounts were closed out at the market price at any point in time. Segregation is intended to protect not only the security of customer funds but the market as well. In most markets, segregation should prevent a run on a firm, as all amounts owed to customers must be secured. Also, segregation facilitates the transfer of accounts from a failing firm to a solvent one and thus the maintenance of customer positions and the continuance of payments on such positions. As such, it is part of

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17/ The CFTC follows the SEC's rules on appropriate depositories for the custodianship of customer funds. See CEA Section 4d(2), 7 U.S.C. § 6d(2), and Commission rules 1.20-1.30 regarding customers' money, security and property, 17 C.F.R. §§ 1.20-1.30 (1993).

the framework intended to protect the customer and prevent a "ripple effect." Rule 4.20 requires funds received by a commodity pool operator ("CPO") from pool participants to be received in the pool's name and prohibits CPOs from commingling pool property with that of any other person.[18]

Internal Controls. The CFTC requires FCMs to be audited annually and any material inadequacies in internal controls must be reported. CFTC rule 166.3 requires each registrant, except an AP who has no supervisory duties, to diligently supervise the activities of its partners, officers, employees and agents, or persons occupying a similar status or performing a similar function, related to its business as a Commission registrant.

Default, Insolvency, Bankruptcy. In the case of an FCM bankruptcy, Chapter 7, Subchapter IV of the Bankruptcy Code, Section 20 of the CEA and part 190 of the CFTC regulations provide for pro rata distribution of customer segregated funds among the public customers of the FCM in priority to all other claims except costs of administration. The Bankruptcy Code also provides certain market protections, in the event of an FCM bankruptcy, including preservation of the right of the clearing organization to liquidate positions and to use margin collateral on deposit notwithstanding the Bankruptcy Code's automatic stay provision.

Recordkeeping and Reporting. Rule 1.35(a) contains the general recordkeeping requirements for FCMs and IBs with respect to

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18/Rule 4.10(d) defines "pool" as "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests."

futures, commodity options, and cash commodity transactions. Commission rules require FCMs to maintain records of all securities and property received from customers to margin, purchase, guarantee, or secure a futures or exchange option transaction, and of each account carried, the name and address of the customer, and the customer's principal occupation or business. FCMs and IBs generally must prepare and keep current ledgers which show each transaction affecting asset, liability, income, expense and capital accounts in accordance with Form 1-FR (or the FOCUS Report if also registered as a broker-dealer), and make a formal computation of their adjusted net capital and their minimum financial requirements as of the close of business each month. FCMs must keep records concerning details of the investment of customer funds, compute each day the customer funds in segregated accounts and the FCM's residual interest in those funds, and prepare a monthly balance of all open positions which brings to the closing or settlement price all open futures and option positions. Rule 1.33 requires an FCM to prepare monthly and confirmation statements. FCMs must provide customer position information to the Commission.

Market Participant Activity

Authorization, Qualification and Good Standing (Probity/Competency). The CEA generally requires registration of futures professionals who engage in sales and order taking activities with the public and of their supervisors. It also requires fitness clearances for principals of firms which carry customer accounts. Sections 8a(2) and (3) of the CEA provide objective

criteria for making determinations regarding fitness for registration. Persons subject to criminal sanctions or who have violated the securities laws, or who have other specified types of disciplinary histories, may be found unfit to receive a registration. NFA requires completion of a competency exam for professionals who deal with the public. Pursuant to statutory directive under the FTPA, the CFTC adopted rules in April 1993, which implement an ethics training requirement for all individual registrants and which authorize the suspension of registration for certain registrants charged with felonies. In April 1993, the CFTC approved rules requiring the registration of floor traders ("FTs") (*i.e.*, persons trading for their own account on or subject to the rules of a contract market). Under these rules FTs are subject to the same background and fitness checks as other registrants.

Sales Practice (Risk Disclosure/Promotional Material). The CFTC requires written disclosure of the generic risks of futures and options trading. Before an FCM or an IB may open a commodity account for any customer, the customer must be provided with a written risk disclosure statement regarding, among other things, the risks, costs and important procedures of trading. Special disclosures are required to be provided to options customers. In addition, the CFTC has required NFA to adopt a "know your customer" rule which generally requires each NFA member to obtain from each customer his age, occupation, income, net worth and previous investment experience and to provide special risk disclosure where

it appears necessary. As noted above, CEA Section 4b prohibits any person, in connection with any order or contract of sale of any commodity for future delivery for another person, from making false or misleading statements in connection with a transaction. The CFTC may bring an action to enjoin the use of misleading advertising, including deceptive telephone sales practices, or sales representations, or commence an administrative complaint based on the use of such material or statements.

Sales Practice Compliance. The CFTC relies on SROs to provide for direct supervision of industry sales practices. The CFTC's role is that of oversight. In that capacity, the CFTC's staff conducts regular reviews of the SROs' sales practice audit programs to determine whether SRO programs meet CFTC standards. The scope of NFA and exchange audits includes, among other things, advertising material, proper order handling, the handling of discretionary accounts, adequacy of internal supervision, and proper handling and disposition of customer complaints.

Regulation of End-Users. CEA Section 9(a)(2) provides that it shall be a felony for any future contracts, or any person to manipulate or to attempt to manipulate the price of any commodity in interstate commerce or to corner or to attempt to corner any such commodity. In order for an exchange to be designated as a contract market for futures or options, its governing board must provide for the prevention of manipulation of prices and the cornering of any commodity by traders on the exchange. The CFTC and exchanges conduct market surveillance to detect and prevent

price manipulation, and the CEA permits the CFTC to institute enforcement proceedings if it has reason to believe that any person other than an exchange is manipulating or attempting to manipulate or has manipulated or attempted to manipulate the market price of any commodity, in interstate commerce, or for future delivery on or subject to the rules of any exchange.

In order to curb excessive speculation, Section 4a of the CEA authorizes the CFTC to set limits on the amount of futures trading which may be done and the number of futures positions which may be held by any one person or by "two or more persons acting pursuant to an express or implied agreement or understanding." Section 4a(c) of the CEA exempts bona fide hedging transactions and positions from any limits imposed by the CFTC. Rule 1.61 requires each exchange, unless exempted by the Commission, to establish speculative limits for all commodities traded on the exchange not subject to Federal limits. Rule 18.04 requires each trader who holds or controls a reportable position (that is, a position in excess of a specified number of contracts) to file a "Statement of Reporting Trader," which essentially requires all identifying information regarding the transactions. Rule 18.05 requires a trader to maintain books and records with respect to all reportable positions and related cash market positions, and to furnish these records upon request to the CFTC. Finally, Rule 19.00 requires reports from, among others, persons who have reportable futures positions any part of which constitutes a bona fide hedging position, and persons holding reportable positions who have

received a special call from the CFTC. The futures SROs use large trader reports for financial surveillance.

The Commission's rules preclude certain types of end-users from engaging in various OTC transactions. Specifically, the Commission has limited the availability of certain OTC products--such as swaps--to specified categories of participants based upon their institutional status or financial resources.[19] Under the exemptive authority conferred by the FTPA, the Commission's exemptive authority with respect to the exchange-trading requirement extends only to "appropriate persons." The Commission recognizes that OTC products are not appropriate for all categories of market participants, in light of their lack of financial or other qualifications to engage in transactions in OTC markets.

Question 2a. To what extent does the CFTC regulate bank derivative activities?

Banks may participate in the futures markets both as end-users and intermediaries and, in either case, are subject to the same regulatory requirements as other market participants. For example, depository institutions may use futures and options transactions for asset and liability management. The potential utility of the futures and options markets for these purposes was recognized by federal bank regulators in approving the use of interest-rate futures and options for purposes of reducing interest-rate exposure.

19/ 17 C.F.R. Part 35.

When trading in the commodity futures and option markets as end-users, banks are subject to all of the provisions of the Act and CFTC regulations applicable to other traders on designated futures and option exchanges. These include the Commission's large trader reporting system, applicable exchange position accountability rules and prohibitions on manipulating the markets.

Banks may also be involved in the futures markets in the role of intermediary. In such cases, the bank will have established an FCM, or IB unit, generally in the form of a separately incorporated affiliate of the bank or the bank's holding company. Such "bank" FCMs or IBs are subject to all of the registration, financial and all other regulatory provisions, including anti-fraud, customer protection and trade practice rules applicable to other FCMs or IBs.

Some recent data illustrate the extent of bank participation in the futures and options on futures markets. Based on position data for September 7, 1993, the number of banks holding reportable financial futures positions ranged from eight in the relatively small IMM Three-Month Euromark contract to 60 banks in the IMM Three-Month Eurodollar contract, the largest financial futures contract with all futures combined open interest of over two million contracts. The percentage of open interest held by reportable banks ranged from 6.7% of the long open interest in the smaller CBT municipal bond contract, to 64.2% of the short open interest in the smaller IMM One-Month LIBOR contract.

With respect to options on futures, the number of banks holding reportable financial options positions ranged from seven in the small IMM U.K. Pound Sterling and IOM Nikkei 225 options, to 82 in Eurodollar options. The percentage of open interest held ranged from 14.8% of the long puts in Nikkei options to 87% of the short calls in the Nikkei.

Regarding the two largest financial futures contracts, the IMM Eurodollar and CBT U.S. Treasury Bond contracts, there respectively were 60 banks holding 39.7 and 35.1% of the long and short open interest, and 25 banks holding 13.8 and 17.6% of the long and short open interest. Similarly, in the two largest financial futures-options, Eurodollar and Treasury Bond options, there respectively were 82 banks holding 36.1 and 52.8% of the long and short calls and 58.3 and 53.4% of the long and short puts, and 65 banks holding 21.9 and 19.6% of the long and short calls and 22.6 and 28.0% of the long and short puts.

Question 2b. Would that authority change if bank derivative activities were transferred to a separately capitalized subsidiary?

To the extent that futures and options on futures activity is conducted in a separately organized and capitalized subsidiary, the CFTC's requirements applicable to such activity would apply to the affiliate, rather than to the bank. For example, only the separate subsidiary registered as an FCM would be required to comply with Commission regulation 1.17, which establishes the minimum financial requirements for FCMs. Conversely, if swaps were to be undertaken

by an affiliate of an FCM, that is not otherwise required to register with the Commission, the unregistered affiliate would have no CFTC-mandated capital requirements for maintaining these positions.

Question 3. Please summarize the CFTC's upcoming report on derivatives, including findings and recommendations.

and

Question 7. What comments does the CFTC have on the growth of over-the-counter derivatives activities? Are you concerned about the adequacy of the regulation in the OTC market for derivative products?

The Conference Committee considering the CFTC's 1992 reauthorization legislation directed the agency to conduct a study of OTC derivative markets to determine the need, if any, for additional regulation of these markets, to analyze the public policy implications of two recent court decisions, and to consider the appropriateness of a single federal regulator for futures, securities, and OTC derivatives. Pursuant to this directive, the Commission prepared a report entitled OTC Derivatives Markets and Their Regulation which was transmitted to Congress on October 25, 1993. The report was prepared in consultation with the SEC and FRB.

The report's central conclusion is that while no fundamental changes in regulatory structure appear to be needed at this time to address issues presented by the growing use of OTC derivatives, greater coordination among federal financial regulators would help assure that federal oversight remains

adequate. Finding that the "systemic and public policy issues suggested by these products are not confined to any single market or the province of any one regulator," the report recommends the establishment of an inter-agency council to consider common approaches to such issues as market information access, transparency, internal management controls, and the development of clearing facilities for OTC derivatives.

The report provides an overview of the OTC derivative markets, including a quantitative characterization of their size and scope. Among the report's key findings:

- Market Size: The widespread use of notional principal in "sizing" the OTC derivatives market may significantly overstate total risk exposure because, for many common OTC derivatives transactions, notional principal is used only to calculate payments between counterparties and is never exchanged. Thus, while available sources indicate that total notional principal in the interest rate and currency swap markets approached $5 trillion at year-end 1992, the true risk exposure in these markets can be assumed to be only a small fraction of that amount.

- Growth/Nature of Market: OTC derivatives have grown rapidly by any measure. The market for swaps appears

to be almost entirely intermediated by institutions that act as dealers.

- Swap Dealers: As of year-end 1991, the number of U.S. swap dealers with notional principal exceeding $10 billion stood at 20. Of U.S. dealers, commercial bank positions were three to five times larger than those of non-banks or U.S. units of foreign dealers. Information provided by the SEC indicates that aggregate notional principal held by major U.S. broker-dealer affiliates on interest rate and currency swaps and forex forwards roughly equaled the aggregate notional value of these dealers' futures positions.

- End-Users: Based on available information, end-users of interest rate and forex derivative products appear to consist primarily of commercial banks and corporate financial subsidiaries (25%), followed by corporations (20%), regional banks (18%), and non-dealer foreign banks (16%). A few large U.S. end-users tend to account for a sizeable proportion of total industry notional principal.

The report also notes that a threshold issue in considering the size and nature of the markets in OTC derivatives is that comprehensive, standardized data about OTC derivative products

and those who use them are currently unavailable. One reason for this is that OTC derivatives market participants are subject to varying degrees of regulatory oversight and, thus, to different disclosure obligations. However, the available data are adequate to draw some basic conclusions, but include gaps suggesting a need for further study.

The report points out that potential systemic risks, including those associated with individual participants (such as credit risk), and those more generally associated with OTC derivatives trading (such as lack of transparency), have been identified by numerous domestic and international regulators, and other interested parties. The report summarizes these risks, and describes steps that have been taken by regulators and market participants to address them.

At this point, existing regulatory structures appear adequate to address issues raised by the growth in OTC derivatives markets. However, given that many of the issues raised to date are clearly inter-agency in nature, benefits could be reaped from greater communication and coordination among regulators with an interest in these markets. This effort would supplement, rather than supplant, the ongoing efforts of these regulators. Accordingly, the inter-agency council being recommended by the Commission would identify and consider common regulatory issues raised by OTC derivative products. Specifically, the CFTC recommends that such a council's agenda consist of the following issues:

Information Access. Perhaps the most pressing issue is the difficulty of obtaining comprehensive information about OTC derivative markets. An early focus of regulators' efforts should be identification of information gaps and data needs; e.g., what information or statistics are needed; what information is available and where such information is located; how information currently collected under risk assessment, capital or other authorities of the various regulators could be more standardized; whether more explicit lead regulator-type arrangements for the collection, exchange and monitoring of information could improve its usefulness and accessibility; and the extent to which existing authorities are sufficient as to unregulated end-users and unregistered or foreign entities performing intermediary functions.

Pricing, Disclosure and Risk Valuation Issues. Another issue that federal regulators may wish to review is the relative lack of transparency in OTC derivatives markets, specifically, whether opacity adversely affects the management of risk. Additionally, regulators could examine the adequacy of financial disclosure by the various types of participants in these markets.

Internal Controls. Federal regulators may also wish to consider how they best can encourage the extension of basic risk control measures to end-users through guidance to regulated participants.

Clearing Facilities for OTC Derivatives. Proposals for clearing various OTC derivatives raise a number of issues

appropriate for inter-agency discussion due to inter-market linkages between clearing systems, the inter-market interests of major participants, and participation by firms in multiple markets.

Scope of Regulatory Oversight. Though the Commission is not recommending additional regulatory controls over OTC derivatives at this time, the inter-agency council may wish to consider issues raised by the presence of dealers in OTC derivative markets that are not otherwise subject to federal regulatory oversight.

The Commission was also asked to assess the public policy implications of two recent court decision, Bybee v. A-Mark Precious Metals, Inc., 945 F.2d 309 (9th Cir. 1991), and Salomon Forex, Inc. v. Tauber, 795 F. Supp. 768 (E.D. Va. 1992), aff'd, No. 92-1406 (4th Cir. October 18, 1993). The Commission intends to carefully monitor how the A-Mark decision is used by litigants and interpreted by courts, but does not believe that the Commission's or the states' law enforcement efforts will be significantly hampered by the decision. As to the Tauber decision, in view of the prevalence of litigation and the courts' lack of unanimity over the scope of the Treasury Amendment, the Commission will consider recommending to Congress legislation that would affirm the CFTC's view that the Treasury Amendment[20] does not extend to the sale of futures and options on foreign currency to the general public.

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[20] 7 U.S.C. § 2(11).

The report's analysis of the single regulator issue focuses primarily on issues raised by a merger of the CFTC and SEC. In the Commission's view, it is unlikely that the anticipated benefits of combining the functions of the CFTC and the SEC into one agency would outweigh the anticipated costs. Merging the CFTC and the SEC would leave unaddressed the emerging issues concerning OTC derivatives which are the primary focus of the report. The systemic implications of OTC derivatives relate to the responsibility of bank regulators to oversee the activities of financial institutions involved with such products as well. The CFTC believes that the cross-market concerns about these products could best be addressed by establishment of the recommended inter-agency council encompassing the SEC, CFTC, and bank regulators to supplement the agencies' current efforts at cooperation, information sharing, and harmonization of regulatory efforts.

Question 4. What competency training, testing or other requirements are there for professionals that regulate or deal derivative products?

Generally, although the Commission has no specific recruitment requirements regarding training with regard to derivatives, many CFTC staff members have a background in the industry or equivalent experience in derivatives. Moreover, the overwhelming number of our staff who regulate derivative products are highly educated professionals; 26% are lawyers, 10% are economists (73% of which have a master's degree or higher), and

6% are auditors. The Commission's staff also includes a number of certified public accountants (CPAs), and the Commission funds CPA training for interested staff members. Expert members of the CFTC staff have assisted the FBI in the development of criminal cases and have conducted training sessions for representatives of foreign jurisdictions interested in establishing derivatives markets.

Recognizing the importance of its staff, the Commission sponsors an on-site training program to enhance staff knowledge in areas of special interest or to provide new employees with basic instruction. For example, courses have been offered on the economics of regulation, on regulatory writing, and on swaps.[21] In addition, each Division of the Commission is required to develop a detailed training plan to ensure that the developmental needs of the Commission and staff are being identified and addressed.

As discussed in the answer to Question 1, above, the Act requires commodity professionals to be registered in order to screen their fitness. Futures commission merchants, introducing brokers, commodity pool operators, commodity trading advisors, floor brokers, floor traders and associated persons must all be registered. Most of the Commission's registration functions have

[21] New employees are provided with a series of training classes regarding the regulation of derivative products. In particular, the Commission offers an introduction course taught by in-house staff and other courses and training experiences as necessary.

been delegated to National Futures Association (NFA), a self-regulatory organization.

In addition to registration, industry professionals are required to meet proficiency standards. The written proficiency examination is a key component of the registration fitness determination.[22] Specifically, NFA Registration Rule 401 generally provides that an individual applying for NFA membership must have taken and passed the National Commodity Futures Examination (the "Series 3 examination") within two years of the date the application is received by NFA.[23]

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[22] The Futures Trading Act of 1982 ("1982 Act") expanded the Commission's authority under Section 4p of the Act, to include all categories of registrant. The 1982 Act also authorized the Commission, in lieu of administering its own written proficiency examination, to provide for such examinations to be given by a contract market or a registered futures association. Section 17(p) of the Act, also added by the 1982 Act, provided that each futures association registered under the Act promptly adopt rules requiring such association to provide for, among other things, proficiency testing for all persons for which such registered futures association has registration responsibilities.

[23] Recently, the Commission approved a change to NFA's rules that allow General Securities Representatives (those persons registered with NASD and who have successfully completed the NASD Series 7 examination) to satisfy the proficiency testing requirement by taking and completing NFA's newly developed Managed Futures Funds Examination (the "Series 31 examination") in lieu of the Series 3 examination, provided their Commission regulated activities are limited to: 1) the solicitation of participation in commodity pools; 2) solicitation of persons to open discretionary accounts with registered CTAs; and 3) the supervision of persons whose activities are so limited.

Question 5. Discuss the coordination and cooperation that exists between the CFTC and other regulators of financial derivatives products.

Over the past several years, financial regulators have come to understand more completely the linkages between various markets and marketplaces. As a result, the CFTC and other financial regulators have sought to forge close, cooperative relations in order to find solutions for perceived inter-market problems.

There are numerous examples of coordination and cooperation between financial regulators. For many years, the Commission has provided a monthly report to the banking regulators regarding the positions held by banks in the futures and options markets. In addition, the Commission's staff conducts quarterly surveillance meetings which are attended by officials from the FRB, SEC, Treasury Department, and Federal Reserve Bank of New York (via teleconferencing,) to identify and resolve inter-agency concerns relating to the expiration of financial futures contracts.

The CFTC also participates in meetings of groups designed to foster coordination of specific intra-market or inter-market regulatory or self-regulatory activities. These groups include the Inter-market Surveillance Group ("ISG"), the Inter-market Financial Surveillance Group, the Joint Compliance Committee, the Clearing Organization and Clearing Bank Roundtable, the Joint Audit Committee and working groups established by the Market Improvements Committee (on which Commission staff participate as observers). Recent cooperative efforts between the CFTC and the

SEC have resulted in companion orders facilitating cross-margining of index futures and options positions, as well as the on-line system for sharing aggregated settlement data and margin and deficit information on clearing members of all futures exchanges and the OCC.

Because of the global nature of trading in the derivative markets, the Commission also has sought to establish cooperative relations with foreign regulators. The Commission currently is a party to 21 agreements with 12 jurisdictions to cooperate on a range of supervisory and enforcement matters. Certain of these arrangements specifically address the financial supervision of firms involved in cross border transactions and facilitate assessments of risks to U.S. FCMs related to their affiliates in other jurisdictions.

International information sharing has been facilitated by increased participation of foreign exchanges as affiliates of the ISG, whose function is to coordinate surveillance for various market abuses. All of the U.S. stock and option exchanges are members of the ISG. Four U.S. futures exchanges on which stock index products are traded participate as affiliates. Currently, the foreign affiliates are The Alberta Stock Exchange, Amsterdam Stock Exchange, The Montreal Exchange, Toronto Stock Exchange, The Securities Futures Authority, and Vancouver Stock Exchange. The CFTC and SEC both participate as observers.[24/]

[24/] All of the groups noted above and their mission is discussed at greater length in the CFTC's Intermarket Coordination Report: A Report to Congress, required by the Market Reform Act of 1990.

Question 6. Please share with the Committee any comments you have on the Group of 30's report on derivative practices and principles, including both recommendations for regulators and dealers.

The G-30 report contains some 20 recommendations for internal risk management practices for OTC derivative market participants. Clearly, the focus of the G-30 report is to provide practical guidance to dealers and end-users, as opposed to regulatory standards. One issue that has been raised about the G-30 report is its lack of a timetable for, and of a system to monitor, the implementation of its recommendations.[25]

The Commission's derivative report discusses internal control mechanisms such as those advocated by the Group of 30 and other commentators on OTC derivatives markets. The Commission notes that the extent to which such recommended practices are actually standard practice for OTC derivatives participants is an open question. In the report, the Commission identifies the subject of internal controls as a potential inter-agency coordinating committee issue. In particular, the Commission suggests that federal regulators discuss how they can best

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[25] David W. Mullins, Jr., Vice Chairman of the Board of Governors of the Federal Reserve System on July 28, 1993, in a speech before the ISDA Summer Conference, observed that:

> As to the role of the Group of Thirty in fostering implementation, one can't help but note the contrast between this report and the Group of Thirty sponsored study of securities clearance and settlement systems. In the latter case, the report set a timetable for implementation of its recommendations and created a secretariat to monitor implementation efforts in more than a dozen countries.

encourage the extension of sound internal controls to end-users of OTC derivative products.