Mr Greenspan gives a testimony on over-the-counter derivatives

Testimony of Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Agriculture, Nutrition and Forestry, United States Senate, on 10 February 2000.

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I am pleased to be here today to underscore the importance of this committee's efforts to modernize the Commodity Exchange Act (CEA) and to express my support for the recommendations for amending the act that were contained in the report by the President's Working Group on Financial Markets entitled *Over-the-Counter Derivatives Markets and the Commodity Exchange Act*.

The need for legislation

Over-the-counter (OTC) derivatives have come to play an exceptionally important role in our financial system and in our economy. These instruments allow users to unbundle risks and allocate them to the investors most willing and able to assume them. A growing number of financial and non-financial institutions have embraced derivatives as an integral part of their risk capital allocation and profit maximization. In particular, the profitability of derivative products has been a major factor in the significant gain in the finance industry's share of American corporate output during the past decade - a reflection of their value to non-financial industry. Indeed, this value added from derivatives itself derives from their ability to enhance the process of wealth creation throughout our economy.

In light of the importance of OTC derivatives, it is essential that we address the legal uncertainties created by the possibility that courts could construe OTC derivatives to be futures contracts subject to the CEA. The legal uncertainties create risks to counterparties in OTC contracts and, indeed, to our financial system that simply are unacceptable. They have also impeded initiatives to centralize the trading and clearing of OTC contracts, developments that have the potential to increase efficiency and reduce risks in OTC transactions. As I shall discuss more fully later in my remarks, rapid changes in communications technology portend that time is running out for us to modernize our regulation of financial markets before we lose them and the associated profits and employment opportunities to foreign jurisdictions that impose no such impediments.

To be sure, the Congress and the Commodity Futures Trading Commission (CFTC) have taken steps to address these concerns about the CEA. The Futures Trading Practices Act of 1992 gave the CFTC authority to exempt OTC derivatives from most provisions of the act. In early-1993 the CFTC used that authority to create an exemption for OTC derivatives that reduced legal uncertainty for a wide range of transactions and counterparties. Unfortunately, some subsequent actions by the Commission called into question market participants' understanding of the terms of the 1993 exemption. Now, under the leadership of Chairman Rainer, the Commission is considering reaffirming and expanding the terms of the 1993 exemption. Nonetheless, even with such an important and constructive step by the Commission, legislation amending the CEA would remain critically important. The greatest legal uncertainty affecting existing OTC transactions is in the area of securities-based contracts, where the CFTC's exemptive authority is constrained. Furthermore, as events during the past few years have clearly demonstrated, regulatory exemptions, unlike statutory exclusions, carry the risk of amendment by future Commissions.

Principles of regulation

Imposing government regulation on a market can impair its efficiency. Thus, when evaluating the need for government regulation, one must clearly identify the public policy objectives of the regulation. As the working group's report discusses, the primary public policy purposes of the CEA are to deter market manipulation and to protect investors against fraud and other unfair practices.

We must of course assess whether government regulation is necessary to achieve those objectives. The regulatory framework of the CEA was designed for the trading of grain futures by the general public, including retail investors. Because quantities of grain following a harvest are generally known and limited, it is possible, at least in principle, to manipulate the price of grain by cornering a market. Furthermore, grain futures prices are widely disseminated and widely used as the basis for pricing grain transactions off the futures exchanges. The fact that grain futures serve such a price-discovery function means that if attempts to corner a market result in price fluctuations, the effects would be felt widely by producers and consumers of grain.

OTC derivatives

The President's working group has considered whether regulation of OTC derivatives is necessary to achieve these public policy objectives of the CEA. In the case of financial OTC derivatives transactions between professional counterparties, the working group has agreed that such regulation is unnecessary and that such transactions should be excluded from coverage of the act. Importantly, the recommended exclusion would extend to those securities-based derivatives that currently are subject to the greatest legal risk from potential application of the CEA.

The rationale for this position is straightforward. OTC transactions in financial derivatives are not susceptible to - that is, easily influenced by - manipulation. The vast majority of contracts are settled in cash, based on a rate or price determined in a separate highly liquid market with a very large or virtually unlimited deliverable supply. Furthermore, prices established in OTC transactions do not serve a price-discovery function. Thus, even if the price of an OTC contract were somehow manipulated, the adverse effects on the economy would be quite limited. With respect to fraud and other unfair practices, the professional counterparties that use OTC derivatives simply do not require the protections that CEA provides for retail investors. If professional counterparties are victimized, they can obtain redress under the laws applicable to contracts generally.

The working group also considered whether the introduction of centralized mechanisms for the trading and settling of what heretofore have been purely bilaterally negotiated and settled transactions would give rise to a need for additional regulation. In the case of electronic trading systems, the working group concluded that regulation under the CEA was unnecessary and that such systems should be excluded from the act, provided that the contracts are not based on non-financial commodities with finite supplies and that the participants are limited to sophisticated counterparties trading solely for their own accounts. Electronic trading of such contracts by such counterparties, it was reasoned, would be no more susceptible to problems of manipulation and fraud than purely bilateral transactions. It was suggested that some limited regulation of such systems might become necessary in the future if such trading systems came to serve a price-discovery function. But it was agreed that creation of a regulatory system for such systems in anticipation of problems was inappropriate. As I have already noted, the vast majority of OTC derivatives simply are not susceptible to manipulation. Thus, even if those contracts come to play a role in price discovery, regulation of the trading mechanism might still be unnecessary.

In the case of clearing systems for OTC derivatives, the working group concluded that government oversight is appropriate. Clearing tends to concentrate risks and responsibilities for risk management in a central party or clearinghouse. Consequently, the effectiveness of the clearinghouse's risk management is critical for the stability of the markets that it serves. Depending on the types of transactions cleared, such oversight might appropriately be conducted by the CFTC under the CEA. Alternatively, it might be conducted by the Securities and Exchange Commission, the Federal Reserve, the Office of the Comptroller of the Currency, or a foreign financial regulator that one of the US regulators has determined satisfies appropriate standards. Provided such government oversight is in place, OTC transactions that would otherwise be excluded from the CEA should not fall within the ambit of the act because they are cleared. If market participants conclude that clearing would reduce counterparty risks in OTC transactions, concerns about legal risks associated with the potential application of the CEA should not stand in their way.

Traditional exchanges

The working group's report does 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 calls for a review of the existing regulatory structures, particularly those applicable to financial futures, to ensure that they are appropriate in light of the objectives of the act. Consistent with the principles of regulation that I identified earlier, the report notes that exchange-traded futures should not be subject to regulations that are unnecessary to achieve the CEA's objectives. The report also concludes that the current prohibition on single-stock futures can be repealed if issues about the integrity of the underlying securities market and regulatory arbitrage are resolved.

I want to underscore how important it is for us to address these issues promptly. I cannot claim to speak with certainty as to how our complex and rapidly moving markets will evolve. But I see a real risk that, if we fail to rationalize our regulation of centralized trading mechanisms for financial instruments, these markets and the related profits and employment opportunities will be lost to foreign jurisdictions that maintain the confidence of global investors without imposing so many regulatory constraints.

My concerns on this score stem from the dramatic advances in information technology that we see all around us. In markets with significant economies of scale and scope, like those for standardized financial instruments, there is a tendency toward consolidation or even natural monopoly. Throughout much of our history this tendency has been restrained by an inability to communicate information sufficiently quickly, cheaply, and accurately. In recent years, however, this constraint is being essentially eliminated by advances in telecommunications. We have not yet seen clear evidence of a trend toward natural monopoly. But the diffusion of technology often traces an S-shaped curve, first diffusing slowly, but then rapidly picking up speed. Once we reach the steep segment of that S-curve, it may be too late to rationalize our regulatory structure.

Already the largest futures exchange in the world is no longer in the American heartland; instead, it is now in the heart of Europe. To be sure, no US exchange has yet to lose a major contract to a foreign competitor. But it would be a serious mistake for us to wait for such unmistakable evidence of a loss of international competitiveness before acting. As our experience with the vast eurodollar markets demonstrates, once markets with scale and scope economies are lost, they are very difficult, if not impossible, to recapture.