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Testimony by

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Chairman

Board of Governors of the Federal Reserve System

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Mr. Chairman, members of the Committee, I welcome the opportunity to discuss Title III of S. 207, the "Futures Trading Practices Act of 1991." Although many of the issues presented in this legislation are highly complex, they are important to the competitiveness and soundness of United States financial markets. Consequently, I commend the Committee for undertaking to explore them fully at this time. There are two provisions of this Title that have been of particular interest to the Board of Governors of the Federal Reserve System, those dealing with margins on stock index futures and those dealing with the exclusivity provisions of the Commodity Exchange Act ("CEA"). As I have noted in previous testimony and Congressional correspondence, the Board supports Federal oversight of margins on stock index futures, which is provided for in S. 207. While we continue to see good reasons for vesting that authority directly with the Commodity Futures Trading Commission ("CFTC") or the Securities and Exchange Commission, we accept the rationale for giving this authority to the Board with latitude to delegate this authority to the CFTC and, of course, would endeavor to discharge that responsibility in a careful and serious manner.

Of more relevance to the hearing today is the matter of the exclusivity provisions of the CEA. I understand that there are currently three alternative approaches to this issue that may be considered; the approach passed by the Agriculture Committee; another approach offered by the CFTC; and a third offered by Senators Bond and Wirth. Each of these approaches revises the

exclusivity provisions of the CEA somewhat differently. I would like to comment on each alternative, but first I would like to review with the Committee some of the history of this issue.

Under the so-called exclusivity provisions of the CEA, contracts for sale of a commodity for future delivery are subject to the exclusive jurisdiction of the CFTC. In addition, transactions in, or in connection with, such contracts can only be conducted on, or subject to, the rules of a contract market designated by the CFTC. The CEA defines the term "commodity" broadly to include not only agricultural products and other goods such as oil, but also services, rights and interests. This language has been interpreted to include contracts for the future delivery of financial interests such as the value of Treasury securities or stock indexes. Although the CEA excludes a number of transactions, including contracts for deferred shipment or delivery and transactions in foreign currency, government securities, and mortgages, it nonetheless can be read to be applicable broadly to many types of financial contracts.

In recent years, a wide variety of new products have been developed to serve the investment and risk management needs of the public. Many of these products have had some of the economic attributes of futures and their legality has been called into question by the exclusivity provisions of the CEA. For example, over the last ten years, the swap markets have developed and grown to involve transactions with $3 trillion in notional

principal amount. The vast majority of these transactions involve interest rates or exchange rates, but in recent years a significant number have involved goods such as oil or precious metals. In a swap transaction, the parties agree to make payments to each other based on changes in interest rates or the value of oil or other products. Unlike exchange traded futures contracts, these transactions are customized to the needs of individual customers and are negotiated on a bilateral basis. Thus, they represent important risk management tools to shield financial institutions and others from fluctuations in interest rates or the prices of the goods or instruments in which they deal. The customizing of these transactions to individual customer needs as to maturity, payment intervals, or other terms can offer significant advantages over standardized exchange-traded products by allowing the customer to adjust its individual risk positions with greater precision.

Nevertheless, the exclusivity provisions of the Commodity Exchange Act have cast a pall over this market, particularly in the area of swaps linked to prices for goods such as oil. Investors and financial institutions have been concerned that such transactions might be interpreted to be the economic equivalent of contracts of sale for future delivery under the CEA and therefore be considered illegal off-exchange futures. Thus, an active market in swaps related to prices of goods did not develop until the CFTC took administrative action to indicate

that it would not view them as illegal off-exchange futures. Even with this exemption, there continues to be concern that developments in the swap markets may run afoul.

This specter has almost surely inhibited innovation, not only in the swaps markets, but also in other financial markets. As early as 1989, the Board expressed its concern to the CFTC that the provisions of the CEA would prevent financial institutions from developing and offering new instruments to manage risk and reduce the flexibility and competitiveness of United States financial markets.

In a number of administrative actions, the CFTC has taken steps to alleviate some of the problems created by the exclusivity provisions of the CEA. These actions have included a Policy Statement indicating that the Commission would not consider interest rate swaps and certain commodity swaps to be illegal off-exchange futures. In addition, the Commission adopted rules excluding certain hybrid instruments, including bank deposits, from the CEA provided that these transactions met certain financial tests. While these were constructive steps, for which we commend the CFTC, administrative actions by themselves cannot eliminate the uncertainty created by the exclusivity provisions, and, therefore, remove the existing impediments to innovation. Administrative actions leave open the possibility that exemptions will be revoked or that private parties will raise the statutory prohibition in an attempt to

invalidate specific transactions. This uncertainty impedes the development of new financial products.

S. 207, as passed by the Agriculture Committee, attempts to address these issues, but does so in a way that is less than satisfactory. The Agriculture Committee version would provide the CFTC with the authority to exempt certain transactions including swap agreements and deposits from the CEA. In order to exempt swap agreements, the CFTC would have to find, after notice and the opportunity for a hearing, that the exemption was in the public interest, the transactions are entered into by a limited class of participants and that they meet a number of restrictions. The Agriculture Committee version also would provide the CFTC with the authority to exempt bank deposits if it determines, after notice and the opportunity for a hearing, that the exemption would not be contrary to the public interest.

While providing for certain exemptive authority, the Agriculture Committee version would perpetuate impediments to innovation in hybrid's and risk management products and would forestall developments in swap markets that could reduce systemic risk. For example, some of the restrictions on the swap exemption included in the Agriculture Committee version have the potential to limit the exemption of some swap agreements currently traded, as well as to inhibit the development of new transactions. The Board also is particularly concerned about the

potential of these provisions to impede the development of multilateral netting arrangements that are designed to reduce counterparty credit risk and the resulting systemic risk to the financial markets. The importance of such arrangements was recently recognized in a report released last November by the Governors of the central banks of the Group of Ten Countries. Moreover, such restriction lead to swap activity and any associated netting arrangements moving offshore.

Further, the general exemptive authority in the Agriculture Committee version is narrow and the CFTC may not be able to make appropriate exemptions and the requirement for a hearing would create a burdensome process that would in itself limit the usefulness of the exemptive authority. In addition, the Agriculture Committee version also suggests that the CFTC would have jurisdiction over some depository instruments and lending transactions, even though banks are subject to a comprehensive system of federal regulation designed to ensure the safety of the institutions and to protect their depositors.

The alternative developed by the CFTC goes further in expanding the CFTC's exemptive authority than the provisions of the Agricultural Committee version, and might be viewed as an improvement over the current law. Nevertheless, this alternative continues to rely on discretionary, and potentially restrictive, exemptive procedures for dealing with swaps and bank deposits rather than the more certain exclusionary approach of the Bond-

Wirth alternative. Further, it does not address lending transactions at all.

The alternative language offered by Senators Bond and Wirth, on the other hand, excludes certain swap transactions as well as certain deposit and lending transactions from the coverage of the CEA altogether, thus avoiding problems that may arise from a cumbersome exemptive process and the potential for revocation of any exemptions that may be granted for these transactions. It also would provide the CFTC with broader discretionary authority to exempt any instrument if the CFTC determines the exemption is consistent with the public interest. The approach taken by this proposed alternative goes further to alleviate the difficulties for the financial markets created by the provisions of the CEA than the Agriculture Committee or CFTC versions and therefore is in our judgment preferable, particularly in the areas of swaps, bank deposits and lending instruments. The exclusion approach also would remove possible conflicts in regulatory jurisdiction that might arise from continued CFTC jurisdiction over swaps. At the same time the limitations on the exclusions ensure that these transactions are subject to Federal oversight or are limited to sophisticated investors.

In conclusion, I believe that it is important that Congress act to clarify the limits of the CEA in a way that

permits innovation in United States financial markets so that they can continue to be strong and competitive.