United States General Accounting Office

GAO

Report to the Honorable
Edward J. Markey,
House of Representatives

October 1997

OTC DERIVATIVES

Additional Oversight Could Reduce Costly Sales Practice Disputes

GAO

United States
General Accounting Office
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General Government Division

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The Honorable Edward J. Markey
House of Representatives

Dear Mr. Markey:

This report presents the results of our review of sales practices for over-the-counter (OTC) derivatives, mortgage-backed securities, and structured notes. On the basis of your request that we review sales practice issues related to OTC derivatives, we report on the applicable federal requirements, extent of end-user satisfaction with dealer sales practices, end-user and dealer views on the nature of their relationship, and actions taken by market participants and regulators to address sales practice issues. Because disputes and concerns were also prevalent for transactions involving mortgage-backed securities and structured notes, we included these products in our review as well.

This report includes recommendations to the President's Working Group on Financial Markets to (1) develop a formal mechanism for collecting data on sales practice issues and (2) consider assisting dealers and end-users in resolving their disagreements over the nature of their relationship as a part of OTC derivatives transactions. Also included are recommendations that the Federal Reserve update its guidance to better address sales practice issues and that the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) collect information on the extent to which securities firms are following the sales practice provisions of voluntary guidance related to OTC derivatives.

As agreed with you, unless you publicly release its contents earlier, we plan no further distribution of this report until 7 days from its issue date. At that time, we will provide copies to interested members of Congress, appropriate congressional committees, CFTC, the Department of the Treasury, the Federal Reserve Board, the Office of the Comptroller of the Currency, SEC, the National Association of Securities Dealers, and the New York Stock Exchange.

Major contributors to this report are listed in appendix X. If you have any questions, please call me at (202) 512-8678.

Sincerely yours,

Thomas J. McCool

Thomas J. McCool
Director, Financial Institutions
and Markets Issues

Executive Summary

Purpose

In 1994, some users of over-the-counter (OTC) derivatives,[1] mortgage-backed securities (MBS),[2] and structured notes[3] experienced large and highly publicized losses. Allegations or evidence of deficient dealer[4] sales practices were associated with some of these losses, raising congressional concerns about whether end-users[5] were adequately protected against such practices. In response to these concerns, the former Chairman of the Subcommittee on Telecommunications and Finance, House Committee Energy and Commerce, requested that GAO determine the prevalence of disputes in the sale of OTC derivatives. Because market participants and others also expressed concerns about sales practices associated with MBS and structured notes, GAO expanded its review to include these products.

To address concerns associated with sales practices for OTC derivatives, MBS, and structured notes, GAO analyzed (1) the federal sales practice requirements applicable to these products and the dealers marketing them; (2) the extent of end-user satisfaction with sales practices, product use, and related disputes and the costs of these disputes; (3) the views of end-users and dealers on the nature of their relationship and responsibilities; (4) the actions dealers and end-users have taken to reduce the potential for sales practice disputes; and (5) the actions regulators have taken to address sales practice issues.

Background

Innovative and often complex financial products known as OTC derivatives can be used to manage financial risks associated with volatility in interest rates, foreign exchange rates, and equity and commodity prices. OTC derivatives can also allow end-users to increase investment yields and reduce borrowing costs. These benefits do not come without risk because using OTC derivatives, similar to using other financial products, can result

[1]OTC derivatives are privately negotiated financial contracts whose market value is determined by the value of an underlying asset, reference rate, or index.

[2]MBS are debt securities that are created from pools of residential mortgages. Investors in MBS receive the interest and principal payments generated by the mortgage pools.

[3]Structured notes are debt securities whose principal and interest payments vary according to specific formulas or as a result of changes in exchange rates or equity and commodity prices; they may also contain derivatives.

[4]Dealers stand ready to act as buyers, sellers, counterparties, or intermediaries for end-users and other dealers.

[5]For simplicity, GAO uses the term end-user to refer to counterparties or customers of dealers in transactions involving OTC derivatives, MBS, and structured notes.

in losses from adverse market movements, credit defaults, or operations errors.

The notional/contract amount[6] outstanding of OTC derivatives was estimated at $47.5 trillion worldwide and $11 trillion in the United States, as of March 1995.[7] The bulk of this volume was in "plain vanilla," or relatively standardized and uncomplicated, OTC derivatives contracts. However, more complex contracts whose values can be based on more than one underlying asset, reference rate, or index were also being used.

In addition to OTC derivatives, a wide variety of MBS and structured notes have been issued by government-sponsored enterprises (GSE)[8] and private companies to finance their operations. In 1996, issuances were $474 billion for MBS and $12 billion for GSE-issued structured notes.

Dealers of OTC derivatives, MBS, and structured notes are primarily U.S. and foreign banks, registered broker-dealers,[9] and affiliates of securities firms and insurance companies. These dealers may receive no federal oversight or be overseen by one or more federal regulators, including the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and various industry self-regulatory organizations (SRO).[10] The federal financial market regulators jointly address issues related to OTC derivatives, MBS, and structured notes through the President's Working Group on Financial Markets. This group,

[6]The notional amount is the amount upon which payments between parties to certain types of derivatives contracts are based. When this amount is not exchanged, it is not a measure of the amount at risk in a transaction. According to the Federal Reserve, the amount at risk, as measured by the gross market value of OTC derivatives outstanding, was $328 billion for U.S. entities, as of March 1995, or about 3 percent of the notional/contract amount. (The gross market value is the cost that would be incurred if the outstanding contracts were replaced at prevailing market prices.)

[7]These estimates were based on a comprehensive survey done by the Bank for International Settlements and represent the most current data available. The Bank for International Settlements, among other functions, provides a forum for cooperative efforts by the central banks of major industrial countries.

[8]GSEs are privately owned financial intermediaries established pursuant to federal law to facilitate lending for purposes that the federal government has deemed socially important, such as education, agriculture, and housing.

[9]Broker-dealers are agents that handle public orders to buy and sell securities. They also act as principals that buy and sell securities for their own accounts.

[10]SROs play an extensive role in the regulation of the U.S. securities and futures industries. SROs include all of the U.S. securities and commodities exchanges, the National Association of Securities Dealers, the National Futures Association, and the Municipal Securities Rulemaking Board. In addition, state agencies also oversee banking, securities, and insurance activities, although this report does not address such oversight in detail.

which is chaired by the Secretary of the Treasury, considers issues concerning the competitiveness, integrity, and efficiency of the financial markets.

To gather information about end-users of OTC derivatives, MBS, and structured notes, GAO sent questionnaires to the financial officers of nearly 2,400 randomly selected U.S. organizations in 1995. Designed to be representative of U.S. public-sector and private-sector entities, the sample was drawn from over 49,000 U.S. organizations that GAO identified as potential end-users of one or more of the products, and the sample was stratified by industry and organization size.[11] GAO received about 1,800 responses to the survey, allowing statistically valid estimates for the population of (1) the level of satisfaction these organizations experienced with dealers' sales practices and (2) the extent to which these products were used across the organizations. In addition, GAO followed-up with about 50 survey respondents to obtain more information about their use of these products and satisfaction with dealer practices.

Results in Brief

The extent to which OTC derivatives are subject to federal sales practice requirements intended to protect end-users varies, depending, in part, on whether they are considered to be securities, futures, or neither. When they are considered to be securities or futures, their sale is covered by the federal securities or commodities laws, and they are regulated by SEC and CFTC, respectively. To the extent that these products are not securities or futures, end-users with sales practice disputes would need to seek redress against a dealer by asserting primarily state statutory or common law claims.[12] In contrast to most OTC derivatives, MBS and structured notes are typically securities and, thereby, subject to the federal securities laws, except when exempted from specific provisions.

The extent to which sales practice requirements apply to the dealers marketing OTC derivatives in the United States also varies, depending on whether the dealer offering them is regulated. When OTC derivatives are marketed by banks, they are subject to supervisory guidance issued by federal bank regulators. This guidance is primarily intended to ensure that OTC derivatives activities do not adversely affect the financial condition of banks. Securities, futures, and insurance firms, unlike banks, typically market OTC derivatives that they consider to be neither securities nor futures from affiliates that are not subject to any direct federal financial

[11]See appendix I for information on the survey sample design.

[12]Common law is derived from judicial decisions rather than from statute.

regulatory oversight, although some individual transactions may be subject to such oversight.

Although sales practice requirements vary by product and dealer, according to GAO's survey of a broad range of U.S. organizations, most end-users were generally satisfied with the sales practices of the dealers with whom they entered transactions. GAO's survey also found that relatively few organizations reported using OTC derivatives. About 10 percent reported using plain vanilla OTC derivatives, and 2 percent reported using more complex OTC derivatives. Within each type of industry, the larger organizations were the predominant users of these products.

Furthermore, GAO's review of regulatory and public records, covering 1993 through 1996, indicated that cases involving actual or alleged deficiencies in dealer sales practices were limited in number. However, the dealers and end-users involved in these cases often experienced significant costs. These were primarily sales practice-related costs associated with compliance risk—such as litigation costs and regulatory fines—and reputation risk—such as reduced revenues and income due to a diminished business or professional reputation.

Although generally satisfied with dealer sales practices, end-users' views on the nature of counterparty relationships sometimes differed from those of dealers. According to GAO's survey, about one-half of all end-users of plain vanilla or more complex OTC derivatives believed that a fiduciary relationship of some sort existed in some or all transactions between them and their dealer. Some end-users told GAO that this meant dealers had an obligation to provide accurate product descriptions and disclose material risks. In comparison, two dealer groups issued guidance asserting that such transactions are conducted on a principal-to-principal, or an "arm's-length," basis unless more specific responsibilities are agreed to in writing or otherwise provided by law. According to this guidance, end-users would be expected to make their own decisions about a transaction without relying on statements made by dealers. Representatives of end-users and dealers have called for both sides to reach agreement on this issue, with some indicating that federal financial market regulators could play a role in resolving differences. Notwithstanding the disagreement over the nature of their relationship, some dealers and end-users have taken steps—individually and collectively—to reduce the potential for sales practice-related disputes to arise.

In addition, bank regulators have taken certain actions to address sales practice issues. In 1993 and 1994, OCC and the Federal Reserve issued guidance for use by their examiners and the banks they regulate covering the marketing of OTC derivatives, MBS, and structured notes. GAO also found that these regulators had conducted examinations that were generally thorough in addressing banks' sales practices. However, in conducting these examinations, regulators addressed areas that were not listed in their guidance, including several key areas in which alleged deficiencies in dealer practices have led to costly disputes with end-users. In 1997, OCC updated its guidance to address these weaknesses. The Federal Reserve has not yet issued updated guidance, but plans to do so by the end of 1997. The revisions are to address the areas not specifically covered in its current guidance.

Although SEC and CFTC do not directly regulate the affiliates that securities and futures firms use to conduct their OTC derivatives activities, SEC and CFTC worked with the most active of these firms to produce one of two sets of voluntary guidance. This guidance presents a framework of management systems and controls for the participating firms to follow related to sales practices. However, the guidance does not provide for SEC and CFTC to receive information about the extent to which participating firms follow its sales practice provisions. Adherence to these provisions is important to promoting market fairness and integrity.

Although GAO found that the extent to which sales practice requirements apply to OTC derivatives and their dealers vary, end-users were generally satisfied with the sales practices of the dealers they used and sales practice disputes were limited in number. However, these findings must be viewed in the context of the relatively small number of end-users and dealers active in these markets as well as their relatively high level of financial sophistication. If new dealers enter the markets, use of complex products becomes more widespread, or marketing to or product use by less sophisticated end-users increases, disputes over sales practices might increase. This could cause the financial market regulators to reconsider whether sales practice requirements for OTC derivatives are sufficient to protect end-users from abusive practices.

Principal Findings

Federal Sales Practice Requirements Vary

The federal sales practice requirements intended to protect end-users of OTC derivatives vary, depending on whether the product involved is a security, futures contract, or neither and on whether the dealer is regulated. OTC derivatives that fall within the definition of a security or futures contract are generally subject to the antifraud provisions of the federal securities or commodities laws, respectively. Their sale is also subject to SEC and CFTC oversight.[13] The antifraud provisions of the securities and commodities laws place certain obligations on those marketing securities or futures. For securities, these obligations include disclosing material information about and assessing the suitability of a product before recommending a transaction. For futures, these obligations include disclosing product risks and obtaining information on the financial condition of the end-user before engaging in transactions. To the extent that a specific OTC derivative product is not covered by federal securities and commodities laws, end-users with sales practice disputes would need to seek redress against a dealer by asserting primarily state statutory or common law claims, such as fraud or breach of fiduciary duty.[14]

Although SEC and CFTC actions can indicate whether they consider certain types of OTC derivatives to be securities or futures, such as when the agencies respond to inquiries about specific proprietary contracts a dealer is developing, these actions have not covered all OTC derivatives. For example, CFTC has exempted certain swaps[15] and other OTC derivatives from almost all provisions of the Commodity Exchange Act (CEA); however, it did so without determining that such products were futures.[16] Furthermore, CFTC did not exempt swaps from the act's antifraud provisions, but such provisions only apply insofar as swaps are found to

[13]SROs assist SEC and CFTC in implementing the federal securities and commodities laws.

[14]End-users could also seek redress under the federal Racketeer Influenced and Corrupt Organizations Act. In addition, dealers may be subject to federal criminal enforcement actions under applicable mail fraud or wire fraud statutes.

[15]Swaps are OTC derivatives contracts that typically require counterparties to make periodic payments to each other for a specified period. The calculation of these payments is based on an agreed-upon amount, called the notional amount, that is not typically exchanged.

[16]CFTC was granted this exemptive authority by the Futures Trading Practices Act of 1992 (P.L. 102-546). See The Commodity Exchange Act: Legal and Regulatory Issues Remain (GAO/GGD-97-50, Apr. 7, 1997).

be futures or commodity options.[17] In addition, SEC and CFTC have taken a cooperative enforcement action against one dealer, Bankers Trust,[18] for violating the antifraud provisions of the federal securities and commodities laws in connection with OTC derivatives it marketed. In contrast to most OTC derivatives, MBS and structured notes are typically securities and subject to the federal securities laws, except when exempted from specific provisions.[19]

The sales practice requirements applicable to OTC derivatives in the United States also vary, depending on whether the dealer offering them is regulated. Banks marketing these products are overseen by federal bank regulators who are responsible for ensuring the safety and soundness of banks. To address this responsibility, bank regulators issued guidance in 1993 and 1994 applicable to the marketing of OTC derivatives that requires banks to take steps to ensure that such transactions are understood and are appropriate for the end-user. Banks marketing MBS and structured notes that are securities are also subject to the antifraud provisions of federal securities laws. As such, they are tasked with providing risk disclosures and assessing the suitability of these products before recommending them to an end-user.

Although SEC oversees securities firms and CFTC oversees futures firms, these firms typically market OTC derivatives that are not securities or futures[20] through affiliates that are not subject to either regulator's direct oversight. Similar to securities and futures firms, insurance firms typically market these products from affiliates that are not subject to direct federal or state financial regulatory oversight. Nonetheless, if SEC or CFTC determined that a specific transaction was a security or a futures contract,

[17]Commodity options give the purchaser the right, but not the obligation, to buy or sell a specified quantity of a commodity or financial asset at a particular price on or before a certain date.

[18]Unless otherwise indicated, Bankers Trust refers to the parent firm—Bankers Trust New York Corporation, which is a bank holding company—and two of its wholly owned subsidiaries—Bankers Trust Company, which is a bank, and BT Securities Corporation, which is a securities broker-dealer.

[19]Structured notes that are hybrid financial instruments could be futures or commodity option contracts if they do not meet the terms and conditions of CFTC's hybrid instrument exemption (17 C.F.R. Part 34). A hybrid financial instrument possesses, in varying combinations, characteristics of forwards, futures, options, securities, and/or bank deposits. Unlike many other derivatives, hybrid financial instruments generally serve a capital-raising function. For the purposes of this report, GAO assumed that structured notes meet the conditions of CFTC's hybrid exemption and, therefore, are securities and not futures.

[20]Firms would also typically market OTC derivatives that CFTC has exempted from the CEA from these unregulated affiliates.

it would be subject to that agency's laws and jurisdiction, absent an agency exemption[21] or a successful court challenge.

After considering the market's characteristics, the President's Working Group on Financial Markets concluded that the existing authority of these agencies as well as current sales practice requirements for OTC derivatives are adequate to protect end-users and the financial markets. Additionally, Working Group participants told GAO that the agencies comprising the group do not routinely collect information on sales practice-related market characteristics, such as changes in the number of disputes or in the types of end-users being offered certain products. Therefore, the Working Group has no formal mechanism for identifying changes in market characteristics that would cause it to reassess the adequacy of existing sales practice requirements for OTC derivatives.

Satisfaction With Sales Practices Was High and Disputes Were Limited, but Losses Were Often Large

According to GAO's 1995 survey of a broad range of U.S. organizations, most end-users were generally satisfied with the sales practices of dealers marketing OTC derivatives, MBS, and structured notes. For plain vanilla OTC derivatives, 2 percent of the organizations that had used these products reported being somewhat or very dissatisfied with the sales practices of the dealers they used.[22] For MBS, 7 percent of the end-users reported being dissatisfied with the dealers they used; for structured notes, 13 percent of the end-users reported being dissatisfied.

GAO's survey found that OTC derivatives were used less frequently than either MBS or structured notes. It found that 10 percent of the population reported using plain vanilla OTC derivatives, while 24 percent reported using MBS and 16 percent reported using structured notes. Also, the reported use of these products was comparatively greater for large organizations than for small organizations.[23] Nonetheless, in certain industries, small organizations reported active use of these products. For example, smaller banks, credit unions, and insurance companies, as a group, reported using MBS and structured notes at about twice the rate as did all other organizations combined.

[21]SEC has not exempted any products from the antifraud provisions of the securities laws. Similarly, except for certain energy products, CFTC has not exempted any products from the antifraud provisions of the CEA.

[22]The number of survey respondents that used more complex OTC derivatives was too small to reliably estimate dissatisfaction.

[23]Large organizations were usually those in the top 10 percent of their respective industry/government grouping on the basis of their assets, revenues, or other indicators of financial size. All other organizations were considered small.

GAO's review of complaints filed with regulators, regulatory enforcement actions, and public records of litigation, from 1993 through 1996, also indicated that sales practice problems involving OTC derivatives, MBS, and structured notes were not widespread. Moreover, a majority of these instances of alleged sales practice problems were attributable to a small number of dealers. The specific concerns generally involved dealers misrepresenting potential transaction risks or offering products that were unsuitable for the end-user.

Using public information and regulatory data, GAO identified 360 end-users losses[24] that involved OTC derivatives, MBS, and structured note transactions with U.S. dealers.[25] These losses totaled over $11.4 billion, with the earliest loss occurring in April 1987 and the latest loss occurring in March 1997. Sales practice concerns were raised by end-users or regulators in 209, or 58 percent,[26] of these losses and were associated with an estimated $3.2 billion in losses. Although many of these losses were large, they involved a relatively limited number of dealers. Of the end-user losses with sales practice concerns, 18 involved OTC derivatives, but one dealer—Bankers Trust—was involved in 9 of these losses. MBS and structured notes were used more often than OTC derivatives and were associated with more sales practice concerns. For these products, GAO identified 190 losses with sales practice concerns; however, 8 dealers were involved in 148 of these losses. Similarly, GAO's review showed that regulators were investigating as many as 44 dealers from 1993 to 1996, but only a small number of the investigations involved multiple end-users. Given the many thousands of transactions in OTC derivatives, MBS, and structured notes and the hundreds of billions of dollars at risk in these transactions over the period reviewed, GAO found that sales practice concerns were not widespread.

Although the number of reported problems was limited during the period GAO reviewed, many of the transactions in which concerns over dealer sales practices arose entailed serious losses for the end-users involved.

[24]The amount of reported losses includes not only realized losses but also unrealized losses as well as losses for which the loss amounts were not reported. In addition, some of the losses may involve products not covered in this report.

[25]The information in this database was compiled from press accounts and other public records as well as from nonpublic regulatory data. Many of the losses are supported by multiple sources, but the accuracy of the information generally was not confirmed.

[26]This percentage is not a statistically valid estimate of the actual extent to which sales practice concerns have been raised in connection with OTC derivatives, MBS, and structured note transactions. It is based on a compilation of losses that is not necessarily representative of the population of such transactions.

For example, Procter & Gamble reported an after tax loss of $102 million on its complex OTC derivatives transactions with Bankers Trust. Various organizations reported losses involving MBS that were as high as $660 million. Additionally, in 1994, Orange County, CA, announced losses totaling $1.7 billion on its use of various products, including structured notes.

The dealers and end-users in these cases also frequently incurred significant compliance and reputation risk costs. For example, Bankers Trust's compliance risk costs have totaled at least $400 million, including regulatory fines, legal fees, and other costs associated with end-user litigation settlements. The impact on its reputation was evidenced, at least in part, by the subsequent declines in its revenues, profits, and stock price. In addition, Orange County faces compliance losses from suits by its investment pool participants, SEC actions against the county's staff, and a countersuit by a dealer, Merrill Lynch. The county's credit rating has also been lowered, causing it to pay higher rates of interest on the debt used to finance its operations.

Disagreement Over Counterparty Responsibilities Increases the Potential for Disputes

According to GAO's survey, about 53 percent of end-users of plain vanilla OTC derivatives believed that dealers had certain fiduciary responsibilities to end-users in some or all cases. In follow-up interviews, end-users told GAO that these responsibilities included accurately describing a product's function and potential performance as well as adequately disclosing relevant risks. Responses to GAO's survey also indicated that an estimated 59 percent of plain vanilla OTC derivatives end-users and a similar percentage of end-users of more complex OTC derivatives relied on dealers to provide investment advice from "some" to a "very great extent" as part of these transactions.

Dealers viewed their responsibilities differently. Two sets of voluntary guidance issued by dealer groups assert, unless altered by agreement between the parties or otherwise provided for by law, that OTC derivatives transactions are conducted at an arm's length, meaning that each party to the transaction—the dealer and the end-user—is responsible for ensuring that the transaction is appropriate.[27] However, some end-users and legal scholars have questioned the reasonableness of asserting that an

[27]The two sets of guidance are the Framework for Voluntary Oversight, issued in 1995 by the Derivatives Policy Group, which is comprised of representatives from the six U.S. securities firms whose affiliates are most active in the OTC derivatives markets, and The Principles and Practices for Wholesale Financial Market Transactions, issued in 1995 by various dealer associations under the auspices of the New York Federal Reserve Bank.

arm's-length relationship always exists between parties to these transactions, particularly when the end-user is unsophisticated or inexperienced in the use of a particular product. Others expressed concern that the dealer-issued guidance does not obligate dealers to fully disclose the risks of the transactions they propose. For their part, dealers told GAO that presentations to end-users are designed to explain potentially useful products and various investment and risk management alternatives, but should not be construed as investment advice that end-users should accept without performing their own internal evaluations. Furthermore, dealers indicated that they would assume more specific responsibilities, such as acting as an investment advisor or fiduciary, if such relationships were agreed to in writing.

Conferences and other forums have provided end-users and dealers opportunities to hear each other's views. However, as of June 1997, the parties had not reached agreement on the nature of their relationship in OTC derivatives transactions, nor did such an agreement appear imminent. Regulators and others have called for more discussions between end-users and dealers on this issue. In addition, some market participants have indicated that federal financial regulators could assist end-users and dealers in reaching agreement.

To reduce the likelihood of losses and related sales practice disputes, some dealers and end-users have acted, individually or as part of groups, to ensure that their internal controls and practices are prudent. Various groups of market participants have also offered guidance and recommended practices to dealers and end-users to address the risks of financial products, including the risks related to the sale of these products. The need for these efforts was demonstrated by the weaknesses in controls and practices that regulators and others found.

Some Improvements in Oversight of Regulated Firms Have Been Made

In late 1993 and early 1994, the Federal Reserve and OCC issued guidance for use by their examiners and the banks they regulate covering the marketing of financial products, including OTC derivatives, MBS, and structured notes. In response to publicized sales practice disputes, in 1994 and 1995, these regulators conducted focused examinations of the largest bank dealers that addressed their sales practices. The scope of these examinations was broader than that required by the 1993 and 1994 Federal Reserve and OCC guidance. Using information from regulators, private groups, and analyses of losses in which sales practice issues were raised, GAO identified various elements that a comprehensive examination could include. Using these criteria, GAO found the bank examinations to be generally thorough in addressing the key elements related to sales practices.

However, GAO found that the bank regulators' new guidance did not address several key areas in which dealer practices led to costly disputes with end-users in the past. For example, it did not direct examiners to assess the adequacy of bank policies and controls related to product risk disclosure, fiduciary or advisory responsibilities, or supervising marketing personnel. In January 1997, OCC expanded its guidance and addressed all of these areas. The Federal Reserve has not yet issued updated guidance. However, Federal Reserve officials provided GAO with a draft of the updated guidance, and the planned revisions would address the elements we identified as missing in the existing guidance. Federal Reserve officials said the agency expects to issue the updated guidance by the end of 1997.

To address ongoing concerns about OTC derivatives use, in 1995, the six securities firms whose affiliates are most active in the OTC derivatives markets cooperated with SEC and CFTC in developing the Framework for Voluntary Oversight.[28] The Framework has resulted in SEC and CFTC receiving information to supplement the reports they receive under prior legislation passed in response to the risks of unregulated activities of registered securities and futures firms. These supplements are to be voluntarily provided and include additional reporting to the regulators, pledges by participating firms to follow certain practices, and external auditor verification of participating firms' adherence to certain provisions of the Framework.[29] However, the additional reporting and the external auditor verification do not extend to the sales practice provisions of the Framework, which include suggestions for alternative ways of disclosing transaction risks and providing accurate pricing information. SEC officials told GAO that they expect participating firms to follow these provisions because doing so is important for ensuring market fairness and integrity.

[28]The six firms are CS First Boston, Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Salomon Brothers.

[29]Because its OTC derivatives affiliate is subject to oversight in the United Kingdom, CS First Boston is not subject to the additional reporting requirements but has committed to adhering to the other elements of the Framework. SEC officials told us that under SEC risk assessment rules, the agency receives copies of quarterly financial reports that the affiliate files with its U.K. regulator.

Changes in Market Characteristics Could Affect the Current Regulatory Approach

Notwithstanding the variance in sales practice requirements that apply to OTC derivatives and their dealers, end-users were generally satisfied with the sales practices of the dealers used and sales practice disputes were limited in number. The individual federal financial market regulators currently monitor OTC derivatives issues as part of their oversight of the firms they regulate, and they discuss new developments in these markets as part of their participation in the Working Group. Although the Working Group concluded that, on the basis of existing market characteristics, no additional sales practice requirements are currently needed for OTC derivatives, the characteristics that contributed to the high level of end-user satisfaction and the limited number of sales practice disputes experienced to date could change as the markets evolve. These changes could include increased market participation by new dealers, more widespread use of complex products, or increased marketing to or product use by less sophisticated end-users. Such changes to market characteristics could cause the Working Group to reconsider whether current requirements are adequate to protect OTC derivatives end-users and the financial markets. However, the Working Group's lack of a formal mechanism for periodically obtaining the information on relevant market characteristics means that it could fail to detect changes that would warrant reassessment of the adequacy of the sales practice requirements for OTC derivatives.

The potential for additional end-user losses to spark costly sales practice disputes could affect the soundness of the financial condition of regulated institutions and perceptions of market fairness and integrity. The potential for these additional disputes is heightened because dealers and end-users have not reconciled their differing views on the nature of counterparty responsibilities in OTC derivatives transactions. So far, the financial regulators have not acted to assist the parties in reaching agreement. However, such a reconciliation of views could have several benefits, including clarifying positions about transaction risks and uncertainty about counterparty roles and responsibilities. The Working Group could provide regulators a forum for assisting end-users. In addition, unaddressed weaknesses in bank guidance correspond to areas where sales practice disputes have arisen, and SEC and CFTC lack information on compliance of unregulated dealer affiliates with the sales practice provisions of the Framework.

Recommendations

GAO recommends that the Secretary of the Treasury, as Chairman of the President's Working Group on Financial Markets, take the following actions:

- Ensure that the Working Group establishes a mechanism for systematically monitoring developments in the OTC derivatives markets to assess whether developments warrant introducing specific federal sales practice requirements.
- Lead the members of the Working Group in considering the extent to which it should assist end-users and dealers in reaching agreement on the nature of their relationship in transactions involving OTC derivatives.

GAO also recommends that

- the Federal Reserve Board Chairman implement planned revisions to the Federal Reserve examination guidance, which are to more specifically address the need to assess the adequacy of banks' policies and controls related to disclosing risks, creating advisory relationships, and supervising marketing personnel and
- the SEC and CFTC Chairpersons establish a mechanism for determining that participating firms are following the sales practice provisions of the Framework for Voluntary Oversight.

Agency and Industry Comments and GAO'S Evaluation

GAO obtained comments on a draft of this report from the heads, or their designees, of CFTC, the Department of the Treasury, the Federal Reserve Board, OCC, and SEC. Comments were also obtained from the National Association of Securities Dealers, the New York Stock Exchange, the End-Users of Derivatives Association (EUDA); the Government Finance Officers Association (GFOA); the International Swaps and Derivatives Association (ISDA); and the National Association of State Auditors, Comptrollers and Treasurers (NASACT). The comments are presented and evaluated in chapter 7.

Overall, no consensus emerged on the benefits of implementing GAO's recommendations. The banking regulators and the associations that represent primarily end-users generally concurred with GAO's findings and/or recommendations. The Federal Reserve also stated that this report makes a useful contribution to assessing the current state of financial market sales practices. OCC commented that the report is comprehensive in evaluating sales practices from the perspectives of dealers, end-users, and regulators. GFOA said this report will be an extremely helpful reference on derivatives, and NASACT stated that it provides an excellent study of sales practice issues facing the OTC derivatives market. In contrast, Treasury and ISDA generally objected to GAO's recommendations, while SEC's views were mixed.

Regarding the recommendation that the Working Group establish a mechanism for systematically monitoring developments in the OTC derivatives markets, SEC and Treasury commented that the Working Group's current efforts, which generally include the principals meeting every 6 weeks and the staff meeting every 2 weeks, are adequate to address market developments. Similarly, ISDA commented that it is not readily apparent that a formal monitoring mechanism would be any more effective than the existing structure. In contrast, EUDA, GFOA, and NASACT supported GAO's recommendation. EUDA indicated that taking the recommended steps—as they relate to this and GAO's other recommendation to the Working Group—will lead to greater market safety and soundness, particularly concerning new dealers or end-users entering the markets.

GAO continues to believe that the Working Group needs a formal mechanism for monitoring the OTC derivatives markets. This report recognizes that the federal financial market regulators monitor the OTC derivatives activities of the firms subject to their respective oversight, and they discuss market developments of which they become aware through their joint participation in the Working Group. However, this report also observes that the agencies that participate in the Working Group do not routinely collect the information necessary to ensure that they are able to systematically detect changes in market characteristics. Thus, the Working Group lacks a formal mechanism for obtaining the necessary information for monitoring market developments related to sales practices. Such a mechanism is important because it could alert the Working Group to the need for reassessing the adequacy of existing sales practice requirements applicable to OTC derivatives. The information to be assessed could include the number and types of new dealers and end-users entering the markets, the types of complex new products being introduced, and changes in the types or sophistication of end-users to whom products are being marketed.

Treasury and ISDA also objected to GAO's recommendation that the Working Group consider the extent to which it should assist end-users and dealers in reaching agreement on the nature of their relationship in transactions involving OTC derivatives. Treasury was concerned that, because such relationships are contractual, no single model may be appropriate. ISDA commented that no need exists for the Working Group to involve itself in mediating between dealers and end-users, that the involvement of market participants and regulators to date has been sufficient, and that the issues involved are complex and federal involvement may not result in an agreement that is widely accepted. SEC commented that it believes the Working Group would be willing to hold discussions with end-users and professional counterparties (dealers); however, it is not necessary for the government to intervene and define contractual obligations for professional and sophisticated counterparties. The Federal Reserve noted that it has recognized the importance of and encouraged voluntary industry efforts in this area, and the three end-user associations supported GAO's recommendation.

GAO continues to support its recommendation that the Working Group consider assisting market participants in reaching agreement on the nature of their relationship in OTC derivatives transactions. This report acknowledges that the issues involved in reaching agreement between dealers and end-users are complex and may not lend themselves to a single, widely accepted solution. For this reason, GAO does not intend that the Working Group impose a model that defines counterparty relationships in OTC derivatives transactions. However, GAO's survey indicated that end-users and dealers do not always agree on the nature of their relationship, as indicated by the majority of end-users reporting that dealers had fiduciary responsibilities in some or all OTC derivatives transactions and that they relied on dealers from some to a very great extent as part of these transactions. To the extent that the differing views of end-users and dealers increase the likelihood of sales practice disputes that expose regulated institutions to material losses or that otherwise effect the sound financial condition of regulated institutions and the fairness and integrity of the markets, we concluded that the federal financial market regulators have an interest in the reconciliation of these differences.

Treasury officials commented that the draft report appeared to be critical of establishing an arm's-length relationship as the default model for OTC derivatives transactions. ISDA officials supported the arm's-length relationship as the default model, noting that it is the appropriate starting place for institutional market participants. This report does not reach a conclusion on the appropriate default model for counterparty relationships. It presents the views of both those who support and oppose an arm's-length relationship as the default model. GAO concludes that the type of relationship and accompanying responsibilities that should prevail in OTC derivatives transactions should be agreed-upon by market participants and recommends that the Working Group consider assisting market participants in reaching agreement on these issues.

The Federal Reserve commented that it has efforts under way that would fully respond to GAO's recommendation that the agency revise its examination guidance to more specifically address the need to assess the adequacy of banks' policies and controls related to disclosing risk, creating advisory relationships, and supervising marketing personnel. In addressing GAO's recommendation that SEC and CFTC establish a mechanism for determining that participating firms are following the sales practice provisions of the Framework, SEC indicated that it is willing to discuss with the affected parties the feasibility of extending the external auditor's role to incorporate a review of sales practice procedures. This appears to be an appropriate first step toward implementing GAO's recommendation. CFTC did not comment on this recommendation.

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Abbreviations

CEA	Commodity Exchange Act
CFTC	Commodity Futures Trading Commission
CMO	collateralized mortgage obligation
EUDA	End-Users of Derivatives Association
GFOA	Government Finance Officers Association
GSE	government-sponsored enterprise
ISDA	International Swaps and Derivatives Association
LDT	leveraged derivative transaction
MBS	mortgage-backed security
NASAA	North American Securities Administrators Association
NASACT	National Association of State Auditors, Controllers and Treasurers
NASD	National Association of Securities Dealers
NAST	National Association of State Treasurers
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency
OTC	over-the-counter
REMIC	real estate mortgage investment conduit
RSWG	Risk Standards Working Group
SEC	Securities and Exchange Commission
SRO	self-regulatory organization
TMA	Treasury Management Association

Introduction

In 1994, we reported on a number of risks associated with the use of over-the-counter (OTC) derivatives,[1] but we did not specifically address sales practice issues. However, since the beginning of 1994, major legal and regulatory actions have been associated with sales practices for OTC derivatives, mortgage-backed securities (MBS), and structured notes, suggesting that the topic deserved closer scrutiny. In addition, we found that an estimated $11.4 billion in reported losses resulted from transactions in such products from April 1987 through March 1997—about $3.2 billion of which involved end-user[2] concerns about dealer[3] sales practices.[4] Federal financial market regulators have an interest in these markets as a part of their responsibilities for ensuring the soundness of regulated financial institutions and maintaining the efficiency and stability of U.S. financial markets. In response to a request by the former Chairman of the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, we reviewed sales practices for OTC derivatives. Because users of MBS and structured notes had also experienced losses that sometimes involved sales practice disputes, we expanded our review to include these products.

OTC Derivatives

OTC derivatives contracts are privately negotiated outside of an organized exchange and have a market value determined by the value of an underlying asset, reference rate, or index (called the underlying). Underlyings include stocks, bonds, agricultural and other physical commodities, interest rates, currency exchange rates, and stock indexes. OTC derivatives are customized to satisfy specific end-user requirements that cannot always be met by the typically more standardized

[1]See Financial Derivatives: Actions Needed to Protect the Financial System (GAO/GGD-94-133, May 18, 1994). We reported on the status of our recommendations in Financial Derivatives: Actions Taken or Proposed Since May 1994 (GAO/GGD/AIMD-97-8, Nov. 1, 1996).

[2]For simplicity, we use the term “end-user” to refer to counterparties or customers of dealers in transactions involving OTC derivatives, MBS, and structured notes.

[3]Dealers stand ready to act as buyers, sellers, counterparties, or intermediaries for end-users and other dealers.

[4]See chapter 3 for a discussion of how we estimated the amount of reported losses and the amount of such losses associated with concerns about dealer sales practices.

exchange-traded derivatives, which include futures[5] and options[6] contracts. Although the economic terms of OTC derivatives are privately negotiated, counterparties commonly elect to use standardized contract language contained in master agreements, such as those developed by the International Swaps and Derivatives Association (ISDA).[7]

Both OTC and exchange-traded derivatives are used by firms around the world to manage market risk[8] by transferring it from entities less willing or able to manage it to those more willing and able to do so. In transferring this risk, OTC derivatives counterparties, unlike their U.S. exchange-traded counterparts,[9] typically remain subject to credit risk—the risk of counterparty default. Derivatives can be more cost-effective for market participants than transactions in the underlying cash markets because of the reduced transaction costs and the leverage[10] that derivatives provide. These benefits do not come without risk because using OTC derivatives, similar to using other financial products, can result in losses from adverse market movements, credit defaults, or operations errors.

As discussed in the following sections, the basic types of OTC derivatives are forwards, options, and swaps. These basic products can be combined with each other in a multitude of ways or with other financial products to create more complex OTC derivatives.

Forwards

Forwards are OTC contracts that obligate the holder to buy or sell a specific underlying at an agreed-upon price, quantity, and date in the future. The price of each forward contract may be agreed upon in advance

[5]Futures contracts obligate the holder to buy or sell a specific amount or value of an underlying asset, reference rate, or index at a specified price on a specified future date.

[6]Options (American-style) give the purchaser the right, but not the obligation, to buy (call option) or sell (put option) a specified quantity of a commodity or financial asset, or to settle for its cash value, at a particular price (the exercise or strike price) on or before a specified future date. For this right, the purchaser pays the seller (writer) an amount called the option premium. A European-style option can only be exercised on its expiration date. Options may be traded on an exchange or OTC.

[7]ISDA is a trade association that represents 318 members worldwide. Its primary membership includes 183 dealers.

[8]Market risk is the exposure to the possibility of financial loss caused by adverse changes in the values of assets or liabilities.

[9]For exchange-traded derivatives, credit risk is borne by clearinghouses that serve as intermediaries between the parties to all transactions by becoming the buyer to every seller and the seller to every buyer. Clearinghouses guarantee the performance of exchange-traded contracts so that parties to these transactions do not have to evaluate the creditworthiness of each other.

[10]Leverage is possible when the capital needed to own, control, or receive financial gains from an investment is less than the investment's full value. Derivatives provide leverage because they require less capital than that needed to directly participate in the underlying markets. Greater leverage results in the possibility of greater gains or losses relative to capital.

or determined at the time of delivery. Forward contracts exist for many underlyings, including traditional agricultural or physical commodities, as well as for currencies (referred to as foreign exchange forwards) and interest rates (referred to as forward rate agreements). Market participants can use forwards to protect their assets and liabilities against the risks associated with rate and price movements, called hedging, or to profit from correctly anticipating rate and price movements. Generally, counterparties to forwards intend either to make or take delivery of the underlying.

OTC Options

OTC options are privately negotiated contracts that can be used for hedging or to profit from correctly anticipating rate and price movements. OTC option contracts also exist for many underlyings, including commodities, currencies, interest rates, and equities. Like other OTC derivatives, OTC options are designed to satisfy specific end-user requirements because specific terms, such as the exercise price, maturity date, and type of underlying, are negotiated.

Swaps

Swaps are OTC agreements that typically require counterparties to make periodic payments to each other for a specified period. The calculation of these payments is based on an agreed-upon amount, called the notional amount, that generally is exchanged only in currency swaps.[11] The periodic payments may be a fixed or floating (variable) amount. Floating payments may change with fluctuations in interest or currency rates or equity or commodity prices, depending on the contract terms. Swaps are used to hedge a risk or obtain more desirable financing terms, and they can be used to profit from correctly anticipating rate and price movements.

Plain Vanilla OTC Derivatives

The simplest derivatives, such as the basic forwards, options, and swaps previously described, are generally called plain vanilla. These OTC derivatives are typically offered by many dealers due to their relative simplicity. As a result, dealer price quotes tend to be very competitive—falling within a narrow range. Also, the price at which dealers are willing to enter into plain vanilla derivatives—the bid-ask

[11]When the notional amount is not exchanged, it is not a measure of the amount at risk in a transaction.

spread[12]—tends to be narrow. Furthermore, large transactions can be executed through one dealer at a single price. Therefore, through the availability of dealers, liquidity is provided for plain vanilla OTC derivatives. Although no official data are available, according to some dealers, plain vanilla OTC derivatives account for 80 to 90 percent of all OTC derivatives activity.

More Complex OTC Derivatives

In contrast to plain vanilla OTC derivatives, the more complex OTC derivatives have features that may make them more difficult to value. Their values may be based on, or derived from, more than one underlying asset, reference rate, or index. An example of a more complex OTC derivative is a "rainbow call option," whose value is based on the highest 1-year yield available from among four underlyings—cash, the 10-year U.S. Treasury note, the 30-year U.S. Treasury bond, and the Standard & Poor's 500 Index.[13] Unlike plain vanilla interest rate swaps in which the notional amount remains constant to maturity, this amount may change during the life of more complex swaps. Some OTC derivatives may be complex because they contain, or have embedded in them, other derivatives—for example, a swap with an embedded option that grants the holder the right, but not the obligation, to terminate the swap contract at some future time. Complex OTC derivatives may have other features, such as a multiplier that magnifies the effect of a price movement in the underlying.

In contrast to plain vanilla OTC derivatives, more complex OTC derivatives are offered by fewer dealers, or they may even be the creation, or proprietary product, of one dealer. Fewer dealers means less liquidity and wider bid-ask spreads, making it more difficult to offset[14] or unwind[15] an earlier transaction at a favorable price. Also, an end-user may find it difficult to independently determine the price or value of a complex OTC derivative that has very complicated terms or that is the proprietary product of one dealer. End-users may attempt to determine the market price of OTC derivatives on the basis of a model. However, the resulting

[12]The bid-ask spread is the difference between the highest price a buyer will pay and the lowest price a seller will accept for a particular product.

[13]The Standard & Poor's 500 Index measures the performance of 500 common stocks.

[14]Offset of an OTC derivatives contract occurs when a market participant enters into an equal but opposite contract. Entering into an equal but opposite contract with the same counterparty eliminates the market and credit risks associated with the original contract. Doing so with a different counterparty eliminates the market risk but not the credit and other risks associated with carrying two contracts.

[15]Unwind of an OTC derivatives contract occurs when the counterparties agree to settle or terminate the original contract or assign one party's contractual obligations to a new party.

price may not correspond closely to what would actually occur in the marketplace, assuming a buyer or seller could be found. The large fees that some more complex OTC derivatives transactions generate are an economic incentive for dealers to develop new products and refine existing products developed by other dealers.

Mortgage-Backed Securities

MBS are debt securities that are created from residential mortgages. They are backed (collateralized) by pools (groups) of mortgages, most of which are 30-year obligations.[16] The process of pooling mortgages and using them to back a new issue of securities is called securitization.[17] Investors in MBS are entitled to receive a portion of the interest and principal payments generated by the mortgage pool. MBS provide funds to the mortgage market by enabling mortgage lenders to sell the mortgages that they originate, thereby replenishing their funds for additional mortgage lending. MBS effectively expand funds available for housing by attracting investors in mortgage loans.

MBS consist of mortgage pass-through securities (also called mortgage-backed certificates) and collateralized mortgage obligations (CMO).[18] Mortgage pass-through securities entitle investors to share on a pro rata basis in all principal and interest payments received from the mortgage pool. CMOs, which are a form of multiple-class securities, entitle investors to share in principal and interest payments in accordance with a payment schedule. The payment schedule may divide the mortgage pool into classes, called tranches, and specify the order in which the tranches are to receive principal and interest payments. CMO tranches receiving the earliest payments, by design, contain less risk than is found in simple mortgage pass-through securities. However, the creation of these relatively

[16]Mortgages may be pooled according to a common characteristic such as their maturity date, as in a pool of 30-year mortgages.

[17]Technically, MBS are a subset of asset-backed securities, which is a term that is used to describe securities created from securitized assets. In addition to mortgages, other types of assets that are securitized in creating asset-backed securities include auto loans, credit card receivables, equipment leases, and corporate bonds. Because market participants distinguish MBS from all other asset-backed products, this report follows that convention.

[18]The term “CMO” is commonly used to refer to both CMOs and real estate mortgage investment conduits (REMIC). Unlike other CMOs, REMICs allow investors to select securities containing the desired levels of risk. This greater selection is possible because REMIC mortgage pools are separated by maturity and credit risk classes, while other CMO mortgage pools are separated only by maturity class. REMIC mortgage pools may contain mortgages of lesser credit quality, while other CMO mortgage pools generally consist of top quality mortgages. As a result, REMICs receive a range of credit ratings, whereas other CMOs normally receive the highest ratings. The overwhelming majority of multiple-class MBS are REMICs.

safe and stable tranches requires the creation of more risky tranches that can be highly volatile in price.

Structured Notes

Structured notes are debt securities[19] that combine elements of traditional debt instruments and OTC derivatives.[20] Interest payments for traditional debt instruments are generally either a stated fixed amount or a variable amount that is based on fluctuations in a specified interest rate. In contrast, the interest and/or principal payments for structured notes may be linked to two or more specified interest or currency rates, or to equity or commodity prices. Structured notes may contain precise formulas describing how these payments are tied to such rates and prices and how they are to be computed. For example, a more complex type of structured note, the inverse floater (also called an inverse floating rate note) pays investors a rate of interest that moves in the opposite direction of a specific market interest rate. Because its value tends to move in the opposite direction of other debt instruments, the inverse floating rate is often used for hedging. Inverse floating rate notes typically contain options that effectively set maximum and minimum rates that will be paid to holders.

Structured notes may also have OTC derivatives embedded in them, such as forwards, options, and swaps. By combining debt and OTC derivatives into a single product, structured notes can provide a more efficient and economic means of managing certain risks than debt and OTC derivatives as separate products. For example, a company can, by purchasing a structured note, limit its credit risk to one party (the issuer) and limit its risk management costs to one product.

Structured notes can be attractive both to investors and issuers. They can be customized to meet investors' preferences for risk and return. Such customization, which is hard to replicate with traditional debt securities,

[19]To the extent that structured notes are hybrid financial instruments, they can be futures or commodity option contracts if they do not meet the terms and conditions of the Commodity Futures Trading Commission's hybrid instrument exemption (17 C.F.R. Part 34). A hybrid financial instrument possesses, in varying combinations, characteristics of forwards, futures, options, securities, and/or bank deposits. Unlike many other derivatives, hybrid financial instruments generally serve a capital-raising function. For the purpose of this report, we assume that structured notes meet the conditions of the Commodity Futures Trading Commission's hybrid instrument exemption and, therefore, are securities and not futures.

[20]A universally accepted definition of structured notes does not exist. For example, the Federal National Mortgage Association and the Federal Home Loan Bank (the central credit system for savings and loan institutions) differ on the types of callable debt they consider to be structured notes. Also, certain other market participants consider all callable debt to be structured notes because the callable feature is an embedded call option.

can be attractive to investors seeking to hedge their unique risks or possibly earn greater returns than those offered by traditional debt securities.[21] The customization is not needed by issuers but is offered to attract investors. Structured notes can be attractive to issuers seeking to lower their cost of capital through access to cheaper financing sources. However, the customized features, though attractive to investors, can contain rate and price risks that are unwanted by the issuer. To offset such unwanted risks, issuers can enter into swaps or options with dealers at the time of issuance. Structured notes are generally of high credit quality because most are issued by highly rated (AAA/Aaa or AA/Aa)[22] corporations or government-sponsored enterprises (GSE)[23] and, therefore, are considered by market participants to have minimal credit risk.

OTC Derivatives, MBS, and Structured Note Markets' Growth and Participants' Activities

Growth in the OTC derivatives market has continued since 1993 because of the popularity of plain vanilla products, which continue to dominate the market relative to more complex products. In contrast, the MBS market and the largest segment of the structured note market experienced significant declines between 1993 and 1995, but they are now showing signs of recovery. OTC derivatives market participants include dealers and end-users. In addition to these participants, the MBS and structured note markets include issuers and underwriters. Various types of financial institutions market OTC derivatives, MBS, and structured notes.

Market Growth

According to the most recent global survey by the Bank for International Settlements,[24] the notional/contract amount outstanding of OTC derivatives was estimated at $47.5 trillion worldwide and $11 trillion in the United

[21]Structured notes also may be preferred by some market participants over traditional debt and derivatives because of certain accounting, regulatory, or tax considerations that are beyond the scope of this report.

[22]According to major credit rating agencies—Standard & Poor's and Moody's—AAA/Aaa are the highest credit ratings, indicating that the capacity to repay debt is extremely strong. AA/Aa indicate a very strong capacity to repay, differing from AAA/Aaa by only a small degree.

[23]GSEs are privately owned financial intermediaries established pursuant to federal law to facilitate lending for purposes that the federal government has deemed socially important, such as education, agriculture, and housing.

[24]The Bank for International Settlements, among other functions, provides a forum for cooperative efforts by the central banks of major industrial countries.

States, as of March 31, 1995.[25] MBS issuances[26] grew from $371 billion in 1990 to a peak of $991 billion in 1993. MBS issuances then declined 45 percent between 1993 and 1994 to $541 billion and declined another 40 percent between 1994 and 1995 to $326 billion. However, total issuances for 1996 grew to $474 billion.

Structured note issuances grew each year between 1990 and 1994, which is the last year for which we were able to obtain estimates for corporations.[27] Structured note issuances for both GSEs and corporations were estimated to be $18 billion in 1990 and $92 billion in 1994. Structured note issuances by GSEs alone were estimated to be $44 billion in 1993. In 1994, they were estimated to be $40 billion and accounted for 43 percent of the estimated structured note issuances for that year. However, in 1995, GSE-issued structured notes declined by 75 percent to $10 billion. This decline was consistent with the significant drop in overall structured note activity that market participants told us they experienced or witnessed that year. In 1996, GSE-issued structured notes, though still below the peak reached in 1993, increased to $12 billion.

The Nature and Extent of Issuer, Underwriter, and Dealer Activities

MBS and structured notes are similar to other securities, such as stocks and bonds, in that they are issued—created and sold to investors—to raise capital. Securities underwriting is a capital-raising activity that involves distributing newly issued stocks and bonds as well as MBS and structured notes, and it is a major function of securities firms and some banks. Often, individual underwriters join with other underwriters and form underwriting groups, or syndicates, to handle a new issue. As underwriters, these firms agree to offer the securities of the issuer to other investors in two different ways. One way that underwriters agree to issue securities is on a "firm commitment" basis, whereby the underwriting firm agrees to accept all of the issued securities from the issuing entity. If all of

[25]Central Bank Survey of Foreign Exchange and Derivatives Market Activity 1995, Monetary and Economic Department, Bank for International Settlements (Basle, Switzerland: May 1996). The Bank for International Settlements conducts this comprehensive survey every 3 years and these amounts represent the most current data available. As previously discussed, the notional amount does not measure the amount at risk in derivatives transactions. According to the Federal Reserve, the amount at risk, as measured by the gross market value of OTC derivatives outstanding, was $328 billion for U.S. entities, as of March 1995, or about 3 percent of the notional/contract amount. (The gross market value is the cost that would be incurred if the outstanding contracts were replaced at prevailing market prices.)

[26]Issuances are not the same as trading volume. Issued securities are counted only once in issuance statistics, but may be counted more than once in trading volume to reflect each change in ownership.

[27]The data do not include structured notes issued by foreign corporations and foreign banks, structured certificates of deposit, structured commercial paper, or structured notes issued in the European medium-term note market. Our data sources were Bloomberg Financial Markets and the Journal of Applied Corporate Finance.

the securities are not sold to other dealers or investors, the firms underwriting the issue will own the unsold portion of the issuance. Underwriters can also agree to offer securities on a "best efforts" basis, whereby any portion of the issuance that is not purchased by other dealers or investors is returned to the issuing entity.

Various Types of Institutions Actively Market OTC Derivatives, MBS, and Structured Notes

Dealers from various industries market OTC derivatives, MBS, and structured notes. Data on the total number of banks, securities firms, and other dealers of OTC derivative products were not available. In the United States, banks account for the majority of OTC derivatives volume. In 1996, the top 10 bank holding companies[28] in terms of assets, all of which market these products, accounted for about 94 percent of the total volume of OTC derivatives held by all banks. Regulated broker-dealers market OTC derivatives.[29] In addition, the affiliates of some securities firms actively market nonsecurities OTC derivatives, with the affiliates of six of the largest firms being the most active. Insurance company affiliates are also somewhat active, with three affiliates actively marketing nonsecurities OTC derivatives in volumes comparable to that of some of the securities firm affiliates. Together, these dealers conduct thousands of OTC derivatives transactions annually. Complete statistics are not available on the total number of dealers marketing MBS and structured notes, but regulators estimated that hundreds of financial institutions market these products. Securities firms account for the largest volumes, but banks and bank affiliates also market MBS and structured notes.

Sales Practices for OTC Derivatives, MBS, and Structured Notes

The sales practices that dealers use to market OTC derivatives, MBS, and structured notes can involve various activities. For example, in discussing potential transactions, dealers may attempt to determine whether a particular product is appropriate or suitable for the end-user by considering several factors, such as the product's complexity relative to the end-user's sophistication as well as the end-user's risk management needs or investment objectives. Dealers may also make disclosures about the product's benefits and risks, such as how the product's value may be favorably or adversely affected by changes in interest rates or foreign exchange rates. This information is sometimes provided to an end-user as part of a "term sheet" that outlines the relevant terms of the transaction, including price, quantity, and maturity dates, and that may also be

[28]Bank holding companies are corporations that own one or more banks.

[29]Broker-dealers are agents that handle public orders to buy and sell securities. They act as principals that buy and sell securities for their own accounts.

included as a part of the confirmation materials that document the transaction.

Another aspect of marketing these products is the establishment of the transaction price. The transaction price is usually negotiated between the dealer and the end-user and can be influenced by market conditions and other factors, including whether the end-user has other business transactions with the dealer, such as loans or securities underwriting. After a transaction is entered into, the dealer may be asked to periodically assist the end-user in determining the current value of the product. End-users are less likely to need such assistance for plain vanilla OTC derivatives that have readily available dealer price quotes or for certain MBS products that have an active secondary market. Dealers may also be asked to unwind an OTC derivatives contract, and this may require one party to pay the other an amount representing any change in the contract's market value.

The nature of the relationship and expectations between dealers and end-users can vary, depending on the product involved. OTC derivatives transactions create obligations between counterparties that continue over the life of the contracts, and thus involve counterparty credit risk. Because of counterparty credit risk, dealers and end-users of OTC derivatives usually seek to enter into transactions with credit-worthy counterparties. Such creditworthiness concerns are important because the counterparties to a swap, for example, are obligated to exchange periodic payments over the life of the contract. Therefore, until the contract matures, each party is at risk that the other may not fully meet its obligations. In contrast, some securities transactions, including those in MBS and structured notes, involve a change in ownership, and thus no additional obligations would exist between the dealer and end-user.

Various Regulators Oversee the Dealers Marketing OTC Derivatives, MBS, and Structured Notes

The dealers of OTC derivatives, MBS, and structured notes may be subject to oversight by various federal or other regulatory bodies.[30] Bank dealers are generally overseen by either the Federal Reserve System, which oversees the bank holding companies and state-chartered banks that are its members, or the Office of the Comptroller of the Currency (OCC), which oversees nationally chartered banks. Of the 10 largest bank OTC derivatives dealers as of 1996, 3 are overseen by the Federal Reserve and 7 are overseen by OCC. In addition, many banks have established separate legal

[30]State agencies also oversee banking, securities, and insurance activities, although this report does not address such oversight in detail.

entities to conduct securities activities, including marketing MBS and structured notes, and these entities are also subject to oversight by the Securities and Exchange Commission (SEC). Banks can also conduct limited securities activities—primarily in securities issued by the U.S. government, GSEs, or certain state or local governments—from the banking entity itself.

As previously noted, the activities of dealers marketing OTC derivatives that are securities as well as those marketing MBS and structured notes are overseen by SEC. The activities of dealers marketing OTC derivatives that are determined to be futures are subject to the Commodity Futures Trading Commission's (CFTC) oversight. Firms that market securities must do so from an entity registered with SEC and subject to various regulations, such as regulations requiring minimum levels of capital. In addition, firms offering futures and commodity options to the public must register with CFTC and comply with the Commodity Exchange Act (CEA) and regulations promulgated under the act, unless otherwise exempted.

Registered securities and futures firms are also required to join and subject themselves to the rules and requirements of a self-regulatory organization (SRO).[31] Such SROs also impose sales practice-related requirements on their members. Most OTC derivatives are not considered to be securities or futures by the dealers offering them. Nonsecurities and nonfutures activities may be conducted in a subsidiary separate from the regulated entity. Consequently, securities and futures firms typically conduct their nonsecurities and nonfutures OTC derivatives activities outside of their registered entities in affiliates that are not subject to SEC or CFTC regulation. CFTC has also exempted swaps and certain other OTC derivatives from the requirement that such activities be conducted in an affiliate subject to its regulation, but CFTC has retained the authority to take action against fraudulent conduct involving exempted products that are futures. (Ch. 2 discusses the regulatory framework for OTC derivatives, MBS, and structured notes in greater detail.)

In addition to working individually, the federal financial market regulators also work collectively to address issues relating to the financial markets. The heads of the Department of the Treasury, CFTC, the Federal Reserve, and SEC comprise the President's Working Group on Financial Markets. Staffs from OCC and other regulatory agencies also participate in this group's activities. The Working Group was established after the 1987

[31]SROs play an extensive role in the regulation of the U.S. securities and futures industries. SROs include all of the U.S. securities and commodities exchanges, the National Association of Securities Dealers, the National Futures Association, and the Municipal Securities Rulemaking Board.

market crash to address issues concerning the competitiveness, integrity, and efficiency of the financial markets, and it is chaired by the Secretary of the Treasury. The Working Group meets periodically to share information and to coordinate regulatory policies and activities, and it also meets on those matters relating to OTC derivatives.

Objectives, Scope, and Methodology

To address congressional concerns associated with sales practices for OTC derivatives, MBS, and structured notes, our objectives were to analyze (1) the federal sales practice requirements applicable to these products and the dealers marketing them; (2) the extent of end-user satisfaction with sales practices, product use, and related disputes and the costs of these disputes; (3) the views of end-users and dealers on the nature of their relationship and responsibilities; (4) the actions dealers and end-users have taken to reduce the potential for sales practice disputes; and (5) the actions regulators have taken to address sales practice issues.

To analyze federal sales practice requirements applicable to these products and the dealers marketing them, we reviewed federal laws and regulations related to sales practices and discussed them with federal financial market regulators. We also reviewed the proposed and final rule issued jointly by the three federal bank regulators[32] regarding bank sales of government securities, which include MBS and structured notes issued by GSEs. In addition, we reviewed the sales practice guidance provided by federal bank regulators for their examiners and the dealers they oversee.

To analyze the extent of end-user satisfaction with sales practices involving OTC derivatives, MBS, and structured notes, we sent questionnaires to the financial officers of nearly 2,400 randomly selected U.S. organizations in 1995.[33] Using the best information we could identify, we constructed a universe of over 49,000 public-sector and private-sector U.S. organizations that might be using these products,[34] including not only the largest organizations, which were determined on the basis of financial

[32]The three federal commercial bank regulators are the Federal Deposit Insurance Corporation (which oversees state-chartered banks that are not members of the Federal Reserve System), the Federal Reserve System, and OCC.

[33]Our survey also included a request for data on asset-backed securities, but because of the relative absence of reported sales practice problems associated with these products, we do not report our survey results for these products, except when they cannot be separated from those for MBS. See appendix I for more details on the survey design, methodology, and results, and see appendix II for a reprint of the survey questionnaire.

[34]See appendix I for a discussion of how we determined which organizations might be using OTC derivatives, MBS, and structured notes.

or other measures of size, but also the smaller organizations in each industry. Our sample was drawn from 19 populations of such organizations. Some of these 19 populations were divided into 2 or more strata on the basis of an appropriate measure of organization size—such as assets, revenues, student enrollment, or census counts. Our questionnaire requested data on the use of these products within the 12 months preceding the survey.

Our questionnaire asked organizations to rate the sales practices of dealers with whom they entered into contracts across the following six dimensions: (1) disclosure of downside risks, (2) quality of transaction documentation provided, (3) suitability of products proposed, (4) competitiveness of pricing and fees, (5) provision of accurate mark-to-market[35] pricing information, and (6) assistance in unwinding transactions. Our questionnaire also asked the organizations to separately rate the sales practices of dealers that proposed contracts but who they did not use for the three applicable dimensions listed above—(1), (3), and (4). We developed these sales practice dimensions on the basis of reviews of regulatory and dealer documents and discussions with regulators, dealers, and end-users. We also asked the organizations to provide overall ratings of sales practices both for dealers with whom the organizations entered into contracts as well as dealers that proposed contracts but who they did not use.

To analyze the extent of product use, we evaluated the approximately 1,800 responses received to our questionnaire. We developed statistically valid estimates of the extent of each product's use across all 19 populations, subject to a 95-percent confidence level, unless otherwise indicated. We compared our results to regulatory data and 27 other recent studies that reported rates of OTC derivatives usage. We also compared our survey results regarding the reasons derivatives were used to studies by other organizations.

To analyze the extent of sales practice disputes between end-users and dealers and the costs of these disputes, we collected data on investigations by securities regulators and on complaints these organizations received in the 4-year period from January 1993 through December 1996. We also reviewed reports and findings of federal regulators and state audit departments for cases where an end-user incurred a loss and subsequently alleged deficient dealer sales practices. Additionally, we used public and

[35]Marking to market is the practice of periodically adjusting the valuation of an asset or liability to reflect current market values.

nonpublic information to compile a list of entities that were known to have incurred losses on OTC derivatives, MBS, or structured notes, and we attempted to identify those cases where sales practice allegations had been raised.

To analyze the views of end-users and dealers on the nature of their relationship and responsibilities, we evaluated the responses of survey respondents who reported being satisfied as well as those who expressed being dissatisfied with dealer sales practices. We also interviewed by telephone 50 survey respondents, including about one-half of whom expressed satisfaction and about one-half of whom expressed general dissatisfaction with dealer sales practices. The respondents were judgmentally selected from the industries we surveyed to include large and small organizations and users of OTC derivatives, MBS, and structured notes as well as nonusers that had heard sales presentations. The interviews were performed, among other reasons, to learn more about (1) why end-users were satisfied or dissatisfied with dealer sales practices and (2) what opinions end-users had on fiduciary relationships.

In addition, we analyzed two sets of voluntary guidance prepared by two dealer groups that address sales practice issues. We also reviewed comments on this voluntary guidance made by end-user associations, legal experts, the U.S. Department of Labor, and others. Finally, we attended industry conferences; reviewed conference documents, court cases, and congressional testimony; and interviewed dealer, end-user, and federal and state regulatory officials regarding the relationship and responsibilities of dealers and end-users in OTC derivatives transactions.

To analyze the actions that dealers and end-users have taken to reduce the potential for sales practice disputes, we interviewed 14 dealers active in marketing OTC derivatives, MBS, and structured notes, including securities firms, banks, and insurance companies; 15 small, medium, and large end-users; 11 dealer and end-user associations; and 5 U.S. federal regulators. We interviewed the end-users and dealers regarding their internal controls and the practices they used to reduce the likelihood of sales practice disputes. In addition, we reviewed studies by other organizations that surveyed end-user management practices and internal controls for OTC derivatives, MBS, and structured notes. We also interviewed regulators and reviewed regulatory examination results regarding weaknesses they identified in policies, procedures, and practices that could lead to sales practice disputes. Furthermore, we reviewed end-user association guidance to members regarding the policies and practices that should be in place before using these products. Finally, we reviewed state legislation whose goal was to minimize the risks that OTC derivatives, MBS, and structured notes pose to governments at the state level or lower and that was enacted by 14 states between January 1994 and September 1996.

To analyze the actions that regulators have taken to address sales practice issues, we interviewed federal financial market regulators. We also reviewed the examination reports and supporting workpapers for the special examinations of the seven largest banks marketing OTC derivatives, MBS, and structured notes. These special examinations were conducted by OCC and the Federal Reserve from mid-1994 through mid-1995. We reviewed the guidance provided by federal bank regulators for their examiners and the dealers they oversee that addresses sales practices and overall risk management responsibilities. We also reviewed congressional testimony, examination policies, guidance, procedures, workpapers, and reports pertaining to the marketing of these products.

We did our work in Chicago, Cincinnati, Dallas, Los Angeles, Minneapolis, and Washington, D.C., between June 1994 and August 1997 in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the heads, or their designees, of CFTC, the Department of the Treasury, the Federal Reserve Board, OCC, SEC, the National Association of Securities Dealers (NASD), and the New York Stock Exchange (NYSE). We also requested comments from the End-Users of Derivatives Association (EUDA),[36] the Government Finance Officers Association (GFOA),[37] ISDA, and the National Association of State Auditors, Controllers and Treasurers (NASACT).[38] The nontechnical comments from these organizations are presented and evaluated at the end of chapter 7 and are reprinted along with additional responses in appendixes III through IX.

[36]EUDA monitors and provides educational material to members on legal, tax, regulatory, and accounting issues affecting OTC derivatives, GSEs, and financial institutions.

[37]GFOA represents approximately 13,000 finance officers from federal, state, provincial, and local governmental entities in the United States and Canada.

[38]The National Association of State Auditors, Comptrollers and Treasurers represents the fiscal and auditing professionsals of state governments and provides for information sharing, training, and policy formulation.

Federal Sales Practice Requirements Vary by Product and Dealer

The federal sales practice requirements designed to protect end-users of OTC derivatives vary, depending, in part, on whether the specific product in question is a security, a futures contract, or neither product. If an OTC derivative falls within the definition of a security or futures contract, the transaction is subject to the applicable sections of the federal laws governing the sale of those products. Although it is not always clear which OTC derivatives fall within these definitions, SEC and CFTC agreed that one dealer's sales practices related to certain OTC derivatives warranted action, and they cooperated in taking enforcement action against the dealer. If an OTC derivative is not covered by the federal securities or commodities laws, an end-user with a sales practice complaint would need to seek redress against a dealer by asserting primarily state statutory or common law claims.[1] In contrast to OTC derivatives, MBS and structured notes are typically securities; therefore, their sale is subject to the federal securities laws, except when exempted from specific provisions.

The sales practice requirements that a dealer must follow when marketing OTC derivatives in the United States also vary, depending on which regulator, if any, oversees its activities. If the dealer is a bank, all of its activities are subject to oversight by one of the federal regulatory agencies responsible for ensuring that banks are appropriately managing their risks. Unlike the requirements applicable to securities, which are intended to protect investors, the requirements placed on banks marketing OTC derivatives are intended primarily to limit the risk that such activities pose to a bank. Securities and futures firms, as well as insurance companies, that offer nonsecurities and nonfutures OTC derivatives typically do so from affiliates that are not subject to direct regulatory oversight.[2] However, should SEC or CFTC determine that a specific OTC derivatives transaction is a security or a futures contract, the transaction would be subject to the respective regulator's jurisdiction, absent an agency exemption or a successful court challenge. Members of the President's Working Group on Financial Markets have stated that the scope of SEC and CFTC authority and existing sales practice requirements are adequate to protect the markets and OTC derivatives end-users.

[1]Common law is derived from judicial decisions, rather than from statute.

[2]Firms would also typically market OTC derivatives that CFTC has exempted from most provisions of the CEA from these unregulated affiliates.

Sales Practice Requirements Vary, Depending on the Product

The sales practice requirements designed to protect end-users of OTC derivatives vary. Some OTC derivatives are subject to the requirements found in the securities laws, including their antifraud provisions and SRO rules. Some OTC derivatives may be subject to similar requirements found in the laws applicable to futures trading in the United States. When federal laws do not apply, disputes involving OTC derivatives would need to be addressed by asserting primarily state statutory or common law claims, such as fraud or breach of fiduciary duty. In comparison, dealers marketing MBS and structured notes that are securities must comply with the federal securities laws.

Some OTC Derivatives Are Subject to the Federal Securities Laws

OTC derivatives that are securities are subject to the sales practice requirements in the federal securities laws that SEC administers. OTC derivatives that are considered to be securities include OTC options on securities, including options on stock indexes. However, such OTC derivatives represent a small portion of the overall volume of these products. According to the most recent global survey by the Bank for International Settlements, the notional amount of equity OTC derivatives—which would include products either previously determined or likely considered to be securities—was $579 billion, or 1.4 percent of the total OTC derivatives contracts outstanding (net of local and cross-border double-counting), at the end of March 1995. The gross market value for equity derivatives was $50 billion, or 2.8 percent of the total OTC derivatives contracts outstanding, at the end of March 1995. Although SEC could not provide comparable data on the extent to which U.S. broker-dealers market OTC derivatives that are securities, an SEC official confirmed that the percentage of such U.S. firms' activities were likely to be similar to those identified in the Bank for International Settlements survey.

The sale of any OTC derivative contract that is considered to be a security is subject to the antifraud provisions of the securities laws that are intended to protect customers and to foster market integrity by prohibiting fraudulent conduct in securities transactions.[3] A dealer can violate these antifraud provisions by making material misstatements about the security being recommended or misleading a customer by omitting information material to the transaction. Under the authority granted by these laws, SEC can act against dealers or their personnel for violating these provisions, including imposing fines on them, restricting their activities, or revoking

[3]As indicated in chapter 1, all of a firm's activities in securities must be conducted in an affiliate registered with SEC as a broker-dealer and subject to that agency's oversight as well as to the rules and oversight of one or more securities industry SROs.

their registration. An end-user may also bring a civil action for a violation of these laws and seek rescission (or undoing of the transaction) or damages.

In addition to complying with the securities laws, dealers marketing OTC derivative securities must comply with the requirements of the securities industry SROs of which they are members.[4] For example, NASD's members offering securities to the public must comply with its Conduct Rules.[5] These rules, among other things, require that a dealer, before recommending a product to an end-user, obtain and evaluate information about the end-user's financial condition and investment objectives to ensure that the product is suitable. (A recently issued NASD rule interpretation that discusses dealers' responsibilities relating to institutional end-users is discussed below.)

The extent to which some OTC derivatives are securities and, therefore, subject to the securities laws is not always clear. SEC officials told us that, as a matter of policy, the agency does not limit its authority by delineating categories of OTC derivatives that are not securities. Relative certainty exists for options on securities, which are considered to be securities under the securities laws. For other OTC derivative products, case-by-case determinations are made. SEC officials said that the agency responds, when requested, to dealer inquiries about whether SEC would consider a specific proprietary OTC derivative contract to be a security. In other cases, dealers independently evaluate the characteristics of individual OTC derivative products to determine whether the products meet the definition of a security as defined in the securities laws. However, when dealers conduct activities in products on the basis of their own determination that the product involved is not a security, SEC or a court may later disagree with their determination. Even if a product meets the definition of a security, SEC officials told us that they can exempt products from various provisions of the securities laws, although, according to agency officials, the agency has never exempted any product from the antifraud provisions of these laws.[6]

[4]These suitability requirements and SRO activities to enforce them are discussed in chapter 6.

[5]Until July 1996, these Conduct Rules were known as Rules of Fair Practice.

[6]Similarly, except for certain energy products, CFTC officials indicated that their agency has not exempted any products from the antifraud provisions of the CEA.

In cooperation with CFTC, SEC took action under the securities laws against Bankers Trust,[7] in 1994, for its conduct in transactions with Gibson Greetings, Inc., involving two OTC derivatives contracts. In acting against Bankers Trust, SEC found that the two transactions involved were securities because they were options on U.S. Treasury securities.[8] Accordingly, SEC found that Bankers Trust violated various sections of the securities laws, including making false statements or omissions in the sale of securities, supplying materially inaccurate valuations of derivatives transactions, and failing to supervise marketing personnel.[9]

Some OTC Derivatives Are Subject to the Federal Commodities Laws

Some OTC derivatives are subject to the CEA, which governs futures trading in the United States and which is administered by CFTC. U.S. firms offering futures and certain options[10] contracts to the public must register with CFTC and comply with the CEA and regulations promulgated under the act as well as with applicable SRO rules. The CEA provides various sales practice-related requirements that must be adhered to by these and other firms offering such products, unless otherwise exempted from such requirements. When establishing accounts, firms are required by SRO rules to obtain certain information pertaining to their customers' financial condition and trading experience. CFTC generally requires that firms make certain disclosures about the risks of products and provide customers with a standardized risk disclosure document before engaging in transactions. The CEA also prohibits fraudulent conduct, including material misstatements and omissions. CFTC can bring actions against firms for violating the CEA. In addition, the CEA allows futures and options customers to pursue private claims against a firm for fraud, but questions have been

[7]SEC's action was taken against Bankers Trust's securities affiliate—BT Securities—as summarized in Securities and Exchange Act Release No. 35136, dated December 22, 1994. Unless otherwise indicated, in this report "Bankers Trust" refers to the parent firm—Bankers Trust New York Corporation, which is a bank holding company—and two of its wholly owned subsidiaries—Bankers Trust Company, which is a bank, and BT Securities Corporation, which is a securities broker-dealer.

[8]The basis for CFTC's action against Bankers Trust is discussed on pages 71 and 72.

[9]Although SEC acted against Bankers Trust's registered broker-dealer affiliate, it could not have taken these sales practice actions unless the transactions in question were securities.

[10]Such options include options on commodities, futures, and stock index futures traded on a board of trade but do not include options on securities, securities indexes, or foreign currencies traded on a national securities exchange. CEA section 2(a)(1)(B), which codified the Shad-Johnson Jurisdictional Accord, excludes options on one or more securities from CFTC's jurisdiction but provides CFTC with jurisdiction over futures (and options thereon) on broadly based stock indexes. Options on securities are regulated by SEC under federal securities laws. In addition, U.S. firms offering trade options are not required to register with CFTC. Trade options are options that are offered to commercial counterparties who enter into these transactions solely for purposes related to their business.

raised about the application of the CEA's fraud provisions to OTC derivatives transactions.[11]

The extent to which some OTC derivatives are subject to the CEA is uncertain.[12] CFTC's regulatory framework is focused primarily on the oversight of exchange-traded futures and certain options and of intermediaries engaging in such transactions on behalf of customers. CFTC has issued regulations that allow trade options[13] on commodities, except on certain enumerated domestic agricultural commodities,[14] to be traded off-exchange. Forwards and certain OTC foreign-currency transactions are excluded from regulation under the CEA,[15] including its antifraud provisions. In 1992, Congress granted CFTC the authority to exempt certain OTC derivatives, including swaps, from almost all of the CEA's provisions.[16] Without determining that swaps were futures, CFTC issued a rule that exempted eligible swaps from all but the CEA's antifraud and antimanipulation provisions.[17] Although CFTC's swaps exemption preserves the CEA's antifraud provisions, the provisions only apply to the extent that swaps are found to be subject to the act.

As previously discussed, CFTC took a sales practice-related action, in cooperation with SEC, against Bankers Trust for activities involving swaps

[11]For example, the judge in Procter & Gamble Co. v. Bankers Trust Co. and BT Sec. Corp., 925 F. Supp. 1270 (S.D. Ohio, May 9, 1996), concluded that Procter & Gamble could not bring a claim under section 4b of the CEA, the general antifraud provision. Section 4b prohibits fraud in connection with a futures contract made "for or on behalf of any other person." The judge concluded that Bankers Trust could not act "for or on behalf of" the company because both were principals; therefore, the typical customer-broker relationship did not exist.

[12]See The Commodity Exchange Act: Legal and Regulatory Issues Remain (GAO/GGD-97-50, Apr. 7, 1997).

[13]See 17 C.F.R. § 32.4 (1996).

[14]On June 9, 1997, CFTC issued an advanced notice of proposed rulemaking in the Federal Register seeking comment on whether it should lift its ban on trade options on domestic agricultural commodities.

[15]The forward exclusion is set forth in CEA section 1(a)(11). The Treasury Amendment excludes certain OTC foreign-currency transactions from the CEA; this exclusion is set forth in CEA section 2(a)(1)(A)(ii). As discussed in our April 1997 report on the CEA, the scope of the Treasury Amendment has been unclear.

[16]CFTC was granted the authority to exempt swaps meeting certain criteria and other OTC derivatives traded among appropriate persons from the CEA by the Futures Trading Practices Act of 1992. See our April 1997 report for a more detailed discussion of CFTC's use of its exemptive authority and related issues.

[17]These provisions do not cover the standardized risk disclosures that would otherwise be required when marketing futures and options contracts subject to the CEA. See C.F.R. Part 35 (1996). In a similar action, CFTC exempted certain energy contracts from the CEA's antifraud provisions but not from its antimanipulation provisions.

and other products that are subject to the CEA exemption. In taking this action, CFTC enumerated the transactions that were involved in the violations but did not indicate whether it considered the transactions to be futures or options contracts subject to the CEA. Instead, it asserted that Bankers Trust, by its conduct, had assumed the role of a commodity trading advisor[18] and had violated the antifraud provisions of the CEA governing such parties' activities.

State Statutory and Common Law Claims Would Be Asserted in Disputes Involving OTC Derivatives That Are Not Subject to Federal Laws

To the extent that OTC derivatives are not covered by either the federal securities or commodities laws, an end-user alleging sales practice misconduct by a dealer would need to seek relief by asserting primarily state statutory or common law claims, such as fraud or breach of fiduciary duty.[19] These claims, which are typically advanced in suits against dealers, are either tort[20] or contract based. Although similar in certain respects, tort claims are based upon the existence of a special relationship that creates a duty owed by the dealer to the end-user, while contract claims are based upon the contractual relationship between the dealer and end-user. Tort-based claims that are typically asserted by end-users include claims of fraud and fraudulent concealment against dealers. End-users may also assert a claim of breach of fiduciary duty. For such claims, a derivatives dealer may have a duty to disclose material information to an end-user if the court finds that an explicit or de facto fiduciary relationship exists. End-users may also assert a claim that the dealer's alleged misstatements or omissions constitute a negligent misrepresentation. In addition, other state law claims may be asserted. For example, under New York law, the judge in the Procter & Gamble case found that an implied contractual duty to disclose in business negotiations exists when one party has superior knowledge not known to the other and the party with superior knowledge knows that the other party is acting on the basis of mistaken knowledge.[21] In resolving these cases, the nature of the relationship between the parties to the transaction is critical to determining the duties that the dealer owes the end-user.

[18]A commodity trading advisor is an individual or firm that, for pay, issues analyses or reports concerning commodities, including the advisability of trading in futures or commodity options.

[19]End-users could also seek redress under the federal Racketeer Influenced and Corrupt Organizations Act. In addition, dealers may be subject to federal criminal enforcement actions under applicable mail fraud or wire fraud statutes.

[20]A tort is a wrongful act (except for those involving a breach of contract) for which damages are imposed.

[21]925 F. Supp. at 1290. The judge concluded that Bankers Trust "had a duty to disclose material information to plaintiff before both the parties entered into the swap transactions . . . and also had a duty to deal fairly and in good faith during the performance of the swap transactions." Id. at 1291.

Contract-based claims do not require the existence of a special duty between the dealer and end-user. For example, an end-user may advance a contract-based claim for rescission due to misrepresentation. This claim would restore the parties to the positions they held before they entered into the contract. If the end-user is a governmental entity, it may assert an ultra vires claim.[22] To support this claim, the end-user may argue that the transaction at issue is unenforceable because it violates a provision in its charter. An end-user may also claim that the contract is voidable because the end-user was a victim of economic duress and, therefore, did not enter into the contract of its own free will. Finally, an end-user may assert that the contract is unenforceable under the applicable statute of frauds. Although the specifics may vary from jurisdiction to jurisdiction, the statute of frauds generally states that contracts in excess of a certain dollar amount that cannot be performed within 1 year are unenforceable unless in writing and signed by the party against whom the contract is being enforced. To reduce the likelihood of the success of this claim, New York amended this statute in 1994 to improve the enforceability of oral OTC derivatives transactions.

MBS and Structured Notes Are Typically Subject to the Securities Laws

MBS and structured notes are typically considered to be securities and subject to the federal securities laws,[23] except when exempted from specific provisions. In the United States, these products are marketed by broker-dealers who are required to register with SEC and become subject to various regulations, such as those requiring minimum levels of capital. When corporations issue these securities, they are subject to the full range of requirements applicable to other corporate securities issued to the public. These requirements include the need to file a prospectus that describes the financial condition of the issuer and explains the risks of investing in the securities. In addition, the marketing of MBS and structured notes is subject to the antifraud provisions of the securities laws previously discussed, as well as the sales practices provisions of SRO rules.

Many MBS and structured notes are issued by GSEs and are considered to be government securities under the federal securities laws. Although dealers marketing these products must comply with the antifraud provisions of the securities laws, just as they would for other securities activities, issuers of government securities are generally exempted from the registration and

[22]This claim would likely be advanced only by governmental entities because corporations typically may not rely on this doctrine to invalidate a contract.

[23]As noted in chapter 1, we are assuming for the purpose of this report that structured notes meet the conditions of CFTC's hybrid instrument exemption and are securities, not futures.

issuance disclosure provisions of the laws that apply to corporate-issued securities. As a result, GSEs are not generally required to obtain SEC approval before offering securities publicly, and such issuances need not be accompanied by prospectuses that identify the issuer and describe its business operations and financial condition.[24] Nevertheless, GSEs have chosen to voluntarily follow the same practices that corporate securities issuers are required to follow. For example, GSE securities issuances are accompanied by prospectuses that contain the same type of disclosures as would be required for other company securities that are registered with SEC. GSE security issuances also typically include a discussion of the structure and risks of the securities being offered.

As previously discussed, dealers marketing securities, including MBS and structured notes, must comply with the requirements of the securities industry SROs of which they are members. NYSE and NASD supervise the majority of dealers offering MBS and structured notes, and both place similar requirements on their members, including requiring firms to determine the suitability of products before recommending them to their customers. Although NASD's suitability rule had long applied to stocks and other securities, the provisions of this rule were not extended to its members' marketing of government securities, including GSE-issued MBS and structured notes, until August 1996.[25]

In recognition of the significant institutional participation in the markets for these securities, NASD also implemented an interpretation of its suitability rule to clarify the responsibilities that dealers have to institutional end-users.[26] Such users are defined by the rule to include any entity other than a natural person.[27] This interpretation provides that a dealer must, on the basis of information either supplied by the end-user or

[24]The Federal Agricultural Mortgage Corporation, commonly known as Farmer Mac, is an exception; its security issuances are registered with SEC.

[25]NASD had been prohibited from applying its full complement of sales practice rules to the marketing of government securities by a longstanding statutory restriction that was removed by subsequent legislation. On August 22, 1996, SEC approved NASD's proposed extension of its rules to these securities with an associated interpretation for applying them to institutional end-users. (This restriction and its impact on NASD's operations are discussed in ch. 6.) Because this restriction applied only to government securities, NASD was able to apply its full complement of sales practice rules to the marketing of corporate-issued CMOs.

[26]Self-Regulatory Organizations; National Association of Securities Dealers, Inc; Order Granting Approval to Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 4 and 5 to Proposed Rule Change Relating to Application of the Rules of Fair Practice to Transactions in Exempted Securities (Except Municipals) and an Interpretation of its Suitability Rule, 61 Fed. Reg. 44100 (Aug. 27, 1996).

[27]The interpretation indicates that its tenets are most appropriately applied to institutional customers with more than $10 million in securities holdings.

otherwise known to the dealer, determine whether the end-user is capable of evaluating the risk of the specific transaction and whether the end-user is making an independent investment decision. The interpretation includes a number of factors that are relevant to making this determination, including the end-user's employment of outside consultants or advisors, the end-user's general level of sophistication and level of sophistication with respect to the particular product, the complexity of the product, and the end-user's ability to understand and independently assess the product. Other relevant information might include whether the end-user had established a pattern of accepting the dealer's recommendations, had access to investment suggestions from other sources, and had supplied information about its investment portfolio to the dealer. If a dealer determines that the end-user is capable of independently evaluating investment risk and making its own decision about the transaction, the dealer's obligation regarding the end-user's suitability is to be considered fulfilled. The interpretation stresses that the determination can only be made on the basis of the particular facts and circumstances of the transaction, including the particular relationship between the dealer and end-user.

Sales Practice Requirements Vary, Depending on the Regulator of the Dealers' Activities

Sales practice requirements also vary, depending on which regulator, if any, oversees the dealers' activities. Bank OTC derivatives activities are subject to requirements of the federal banking regulators as a part of their oversight of all bank activities. Banks marketing MBS and structured notes are now expected to comply with suitability rules similar to those that apply to securities firms offering such products. Banks marketing OTC derivatives, MBS, and structured notes may also be subject to oversight by different regulators, depending on which legal entity within their corporate structure conducts these activities. Securities, futures, and insurance firms typically conduct their nonsecurities and nonfutures OTC derivatives marketing in affiliates not subject to direct federal oversight, although some individual transactions may be subject to oversight. Members of the President's Working Group on Financial Markets have stated that the scope of SEC and CFTC authority and existing sales practice requirements are currently adequate to protect the end-users of derivatives and the markets.

Bank Activities Are Regulated to Protect Their Financial Condition

All of the activities of banks are subject to oversight by at least one federal regulatory agency—either the Federal Deposit Insurance Corporation, the Federal Reserve, or OCC. These regulators are responsible for ensuring the safety and soundness of banks to protect depositors and the federally administered Bank Insurance Fund. The regulators address this responsibility by placing various requirements on banks, including periodic reports of financial condition, maintenance of minimum capital levels, and periodic bank examinations. Almost all of the banks actively marketing OTC derivatives, MBS, and structured notes are overseen by either the Federal Reserve or OCC.

In response to the large increase in the volume of bank activity in OTC derivatives and other financial products over the last decade, bank regulators revised and expanded the guidance provided to examiners and banks to more specifically address the risks that these activities pose, including those risks related to sales practices. Previously, according to bank regulatory officials, the only bank sales practice-related guidance was “know your customer” rules under which regulators expected banks to obtain sufficient information about customers’ financial condition and business activities to prudently extend credit or engage in other financial transactions with them.

In 1993 and 1994, OCC and the Federal Reserve each issued new guidance that more specifically addresses sales practice issues as a part of a bank’s overall responsibilities for managing the risks of its financial activities, including OTC derivatives. Both sets of guidance place generally the same requirements on examiners and banks. OCC’s October 1993 guidance[28] directs the banks it oversees to assess and document the appropriateness of transactions, as a part of managing the credit risk arising from these transactions. In a follow-up 1994 OCC interpretation,[29] OCC states that consistent with safe and sound practices, banks should not recommend transactions that they know, or have reason to know, would be inappropriate for counterparties on the basis of available information. According to the interpretation, banks should also determine whether proposed transactions are consistent with counterparties’ policies and procedures, as these are known to them. Specifically, banks should understand the risks that counterparties are trying to manage or assume through the use of derivative products. The interpretation also requires that banks ensure counterparties understand the general market risk of transactions and explain, particularly for those counterparties that they

[28] Banking Circular 277: Risk Management of Financial Derivatives, OCC (Washington, D.C.: Oct. 1993).

[29] Risk Management of Financial Derivatives: Questions and Answers Re: BC-277 (OCC Bulletin 94-31), OCC (Washington, D.C.: May 1994).

determine lack sophistication, how transactions will achieve the counterparties' objectives.[30]

The Federal Reserve's December 1993 guidance[31] to the banks it oversees states that sound business practices require member banks to take steps to ascertain the sophistication of derivatives counterparties, including whether counterparties understand the nature and risks of transactions. If a bank determines that its counterparty is unsophisticated, either generally or with respect to a specific transaction, the guidance directs it to educate the counterparty about the risks associated with the proposed transaction. Furthermore, the guidance provides that when a bank recommends a derivatives transaction to an unsophisticated counterparty, it should ensure that it has adequate information about the counterparty on which to base its recommendation. In the guidance issued to examiners,[32] the Federal Reserve indicates that banks should have established standards for complex products to ensure that counterparties are not entering into transactions where they fail to understand the risks. The guidance also notes that bank management should be cognizant of the potential for activities in these products to result in financial losses and harm the bank's reputation.

The goal of the guidance applicable to OTC derivatives issued by the Federal Reserve and OCC is primarily to protect the safety and soundness of banks rather than their counterparties or the end-users of the products banks offer.[33] The requirements banks are to follow when marketing such products are designed to reduce their exposure to risk of loss from end-user default or transaction disputes.[34] Although the Federal Reserve's guidance places additional sales practice requirements on banks, its guidance also states that end-users are ultimately responsible for their own transactions. Regarding OCC's guidance, a senior OCC official

[30]As discussed in chapter 6, OCC subsequently issued more detailed guidance in 1996 and 1997 with additional sales practice-related expectations for the banks it oversees; however, this additional guidance does not change the requirements described in this chapter.

[31]Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations, [SR 93-69 (FIS)], Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System (Washington, D.C.: Dec. 1993).

[32]Trading Activities Manual, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System (Washington, D.C.: Mar. 1994).

[33]Bank regulatory officials indicated that bank dealers' compliance with these requirements should have the indirect effect of protecting counterparties and end-users from abusive practices.

[34]Under federal banking laws, aggrieved end-users have no right of private action or redress similar to that provided by federal securities or commodities laws. As a result, aggrieved end-users must seek redress under state statutory and common law.

explained that it does not task banks with determining the suitability of OTC derivatives transactions for their customers, but the guidance is meant to ensure that the activities are being conducted in a safe and sound manner. According to the official, a suitability rule would represent a fundamental change in the relationship between a bank and its customers because certain transactions, such as loans, deposits, and letters of credit, are entered into on a principal-to-principal basis. Although intended primarily to protect banks, bank regulator officials told us that the interests of end-users would indirectly be protected by banks complying with the prudent practices recommended in bank guidance.

Bank Regulators Adopted Additional Requirements for Dealers Marketing Securities

Bank regulators have placed additional requirements on banks that market securities. Banks marketing securities must now comply with substantially the same suitability rule as securities firms that market such products. In 1994, the Federal Deposit Insurance Corporation, the Federal Reserve, OCC, and the Office of Thrift Supervision issued a joint statement applicable to banks and thrifts marketing nondeposit investment products, including mutual funds and annuities, to retail customers.[35] This joint statement also applied to banks marketing government securities, including GSE-issued MBS and structured notes to retail customers. Although securities products have always been subject to the antifraud provisions of the securities laws, the interagency statement tasks banks offering nondeposit investment products—some of which are not securities—with determining the suitability of such products before recommending them to retail customers.

Bank regulators have also recently approved additional sales practice rules for banks that deal in government securities. As authorized by the Government Securities Act Amendments of 1993, the three federal bank regulatory agencies—the Federal Reserve, the Federal Deposit Insurance Corporation, and OCC—issued a March 1997 joint rule on bank sales of government securities, including GSE-issued MBS and structured notes.[36] In addressing dealers' obligations to determine suitability before making a recommendation to institutional end-users, the rule uses language similar to the recently approved NASD rule, as previously discussed. As of July 1, 1997, which was the effective date of the banking regulators' rule, banks

[35]Interagency Statement on Retail Sales of Nondeposit Investment Products, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, OCC, and Office of Thrift Supervision (Washington, D.C.: Feb. 15, 1994).

[36]Government Securities Sales Practices, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, OCC, and Office of Thrift Supervision (Washington, D.C.: Mar. 12, 1997).

and securities firms marketing these securities became subject to essentially the same rules regarding determining suitability before recommending purchase of GSE-issued MBS and structured notes.

Banks Market Products From Various Legal Entities That May Be Subject to Oversight by Different Regulators

Banks market OTC derivatives, MBS, and structured notes from various legal entities within their organizational structures, and this affects which regulators, if any, oversee these activities. Regulators indicated that most banks use bank employees to market OTC derivatives. However, some also use their securities affiliates' staffs to market them, depending on corporate preferences or the extent to which securities are also being offered to their customers. Nevertheless, any OTC derivative marketing activities by such securities affiliate staff would not be subject to the securities laws unless the product being marketed is a security. A bank examiner explained that banks' use of the same staff to market both securities and nonsecurities OTC derivatives may reflect an effort to have marketing staff be able to select the most appropriate product for the specific risk management needs or investment objectives of an end-user, regardless of the regulatory status of the individual products.

The corporate entities used by banks to market MBS and structured notes also vary. The Banking Act of 1933, commonly known as the Glass-Steagall Act, allows banks and their affiliates to underwrite and deal in certain types of securities known as bank-eligible securities. These include GSE-issued MBS and structured notes. The act generally prohibits banks from underwriting and dealing in bank-ineligible securities, such as those issued by corporations, including MBS[37] and structured notes. Federal regulators have provided banks with limited authority to underwrite and deal in ineligible securities through affiliates of their holding company. These affiliates—called Section 20 affiliates after the relevant section of the act—are permitted to engage in securities underwriting and dealing as long as the affiliate generates no more than 25 percent of its gross revenues from ineligible securities.[38] Regulators told us that most banks with such affiliates market MBS and structured notes exclusively from these entities to provide as large a revenue base as possible for conducting activities in ineligible securities. Because these Section 20 affiliates are also registered as broker-dealers with SEC, they are also subject to

[37]To distinguish them from GSE-issued securities, MBS issued by corporations are called "private label."

[38]The previous limit on revenues derived from ineligible securities activities for Section 20 affiliates was 10 percent, but the Federal Reserve raised the percentage to 25 percent, effective March 6, 1997. However, national banks may sell their own assets in a securitized form and, therefore, may be deemed underwriters for purposes of the securities laws, but not for purposes of the Glass-Steagall Act.

examinations by SEC and securities industry SROs to ensure that they comply with the sales practice requirements of the federal securities laws when selling securities.

Unregulated Affiliates Are Not Subject to Direct Federal Oversight, but Regulators May Assert Jurisdiction Over Specific Products

Affiliates of securities, futures, and insurance firms that market nonsecurities or nonfutures OTC derivatives are not directly regulated by SEC or CFTC.[39] Securities and futures firms are allowed to conduct activities in nonsecurities and nonfutures products outside of the entities that are subject to direct SEC or CFTC oversight, respectively. Some securities firms have established one or more separate affiliates that conduct OTC derivatives activities. For example, because counterparties are sensitive to the credit risk inherent in most OTC derivatives contracts, several securities firms have created separately capitalized subsidiaries to conduct activities in these products. These affiliates were specifically structured to receive the highest credit ratings by rating agencies to increase their attractiveness as counterparties to end-users of these products. SEC officials told us that firms generally cite the stringent treatment that OTC derivatives receive under SEC and CFTC capital requirements as the reason firms do not conduct such activities in regulated entities, rather than a desire to avoid sales practice requirements.

Some insurance firms also market OTC derivatives to end-users. However, unless the products involved are subject to SEC or CFTC jurisdiction, the OTC derivatives marketing activities of these firms are not subject to federal regulatory oversight. The regulation of the insurance industry is primarily a state responsibility.[40] However, officials from the state insurance regulatory commissions of the states with major insurance company dealers of OTC derivatives, including New York, New Jersey, and Delaware, told us that they did not directly oversee insurance firms' marketing of these products because such activities were conducted in noninsurance affiliates.

As previously discussed, to the extent that nonsecurities OTC derivatives activities are legally conducted outside of a regulated firm, they are not subject to direct SEC or CFTC oversight. By offering these products from

[39]As discussed in chapter 6, the affiliates of securities and futures firms that market OTC derivatives are subject to indirect SEC and CFTC oversight under the risk assessment authority Congress granted to these agencies in 1990 and 1992, respectively. Also, as discussed in chapter 6, SEC and CFTC worked with the firms most active in the OTC derivatives markets to establish a set of voluntary guidance for participating firms to follow. The guidance presents a framework of management controls and risk measurement practices.

[40]Congress has strictly limited the extent to which federal law preempts state insurance law.

affiliates, dealers have, in effect, determined that these products are not subject to the securities laws or most provisions of the CEA. However, SEC, CFTC, or a court could determine that a product offered by an unregulated affiliate is subject to the provisions of the federal securities or commodities laws, respectively, and take action against the dealer when they find violations of these laws.

The Working Group Concluded That the Scope of Regulators' Authority and Sales Practice Requirements Are Adequate

According to SEC and CFTC officials, the President's Working Group on Financial Markets has discussed the need to expand SEC and CFTC authority over and sales practice requirements for OTC derivatives. On the basis of these discussions and information collected on an ad hoc basis by various members, the officials comprising the Working Group concluded that no changes requiring legislation are currently needed to protect the financial markets or end-users of derivatives. SEC and CFTC officials also told us that their agencies have been able to take appropriate actions under their existing authorities when problems have arisen. For example, as previously discussed in this chapter, SEC and CFTC took a cooperative action against Bankers Trust for its conduct in OTC derivatives transactions with Gibson Greetings. The legal entity cited was BT Securities, which is a subsidiary of Bankers Trust.[41] SEC and CFTC officials told us that if they believed their authority was insufficient, they would ask Congress to address the issue.[42]

One member of the Working Group, the Chairman of the Federal Reserve, indicated in a February 1997 speech that institutional end-users of OTC derivatives have demonstrated their ability to protect themselves from fraud. He noted that when dealers have engaged in deceptive practices, end-users have been able to obtain restitution either by taking legal action or threatening to do so. He indicated that, while the threat of legal action by end-users may deter misconduct, dealers are motivated by the need to stay competitive, which requires that they maintain a good reputation.

Officials familiar with the operations of the Working Group indicated that the various members have shared information relating to OTC derivatives sales practice issues. The members obtained this information through special study efforts or otherwise collected it during their routine

[41]BT Securities is an affiliate of Bankers Trust Company and is authorized to conduct securities activities under section 20 of the Federal Reserve Act. Both are subsidiaries of Bankers Trust New York Corp., which is a bank holding company.

[42]CFTC has offered Congress legislative amendments to address technical issues to clarify its authority under the CEA in several respects. As of , Congress had not enacted these amendments.

oversight activities. However, Federal Reserve and SEC officials indicated that data on market characteristics relevant to sales practice issues, such as increased market participation by new dealers, more widespread use of complex products, or increased marketing to or product use by less sophisticated end-users, was not routinely collected by their agencies. Furthermore, they said that no formal mechanism or expectation existed for the members to continue collecting and sharing such information on a periodic basis.

Satisfaction With Sales Practices Was High and Disputes Were Limited, but When Disputes Occurred Losses Were Often Large

According to our 1995 survey, end-users were generally satisfied with the sales practices of dealers offering OTC derivatives, MBS, and structured notes. Product use varied with end-users reporting less use of OTC derivatives than of MBS and structured notes, and larger organizations generally reporting more use of all of the products than smaller organizations. Review of regulatory and other data indicated that cases involving sales practice disputes were not widespread. However, when disputes did arise, the losses were often large, with dealers and end-users generally experiencing other financial impacts. These included direct costs from litigation or regulatory fines and indirect costs, such as reduced revenues and income.

Most End-Users Were Generally Satisfied With Dealer Sales Practices

According to our 1995 survey of a wide range of U.S. organizations, most end-users were generally satisfied with the sales practices of the dealers that marketed OTC derivatives, MBS, and structured notes to them. The rates of reported overall dissatisfaction with the sales practices of dealers used ranged from as low as 2 percent to as high as 13 percent across the products. End-users reported lower rates of dissatisfaction with the sales practices of dealers they had used than for dealers that made presentations to them but were not used. Finally, the respondents to our survey provided generally consistent reasons for any dissatisfaction with specific elements of dealer practices.

Few End-Users Reported Dissatisfaction With Dealers Used

When asked to rate the sales practices of the dealers with whom they had entered into transactions, few end-users of OTC derivatives, MBS, or structured notes reported dissatisfaction. To obtain information on how satisfied organizations who had heard proposals were with these dealers' sales practices, we asked the organizations we surveyed to indicate whether they were "very satisfied," "somewhat satisfied," "neither satisfied nor dissatisfied," "somewhat dissatisfied," or "very dissatisfied" for each of the products included in this review.[1] They were asked to provide these ratings for the following six individual elements of sales practices: (1) disclosure of downside risks, (2) quality of transaction documentation provided, (3) suitability of products proposed, (4) competitiveness of pricing and fees, (5) provision of accurate mark-to-market pricing information, and (6) assistance in unwinding transactions. Respondents were also asked to provide a rating of their overall level of satisfaction or dissatisfaction with dealer sales practices. In addition, survey respondents were asked to provide ratings in these categories for (1) dealers they used

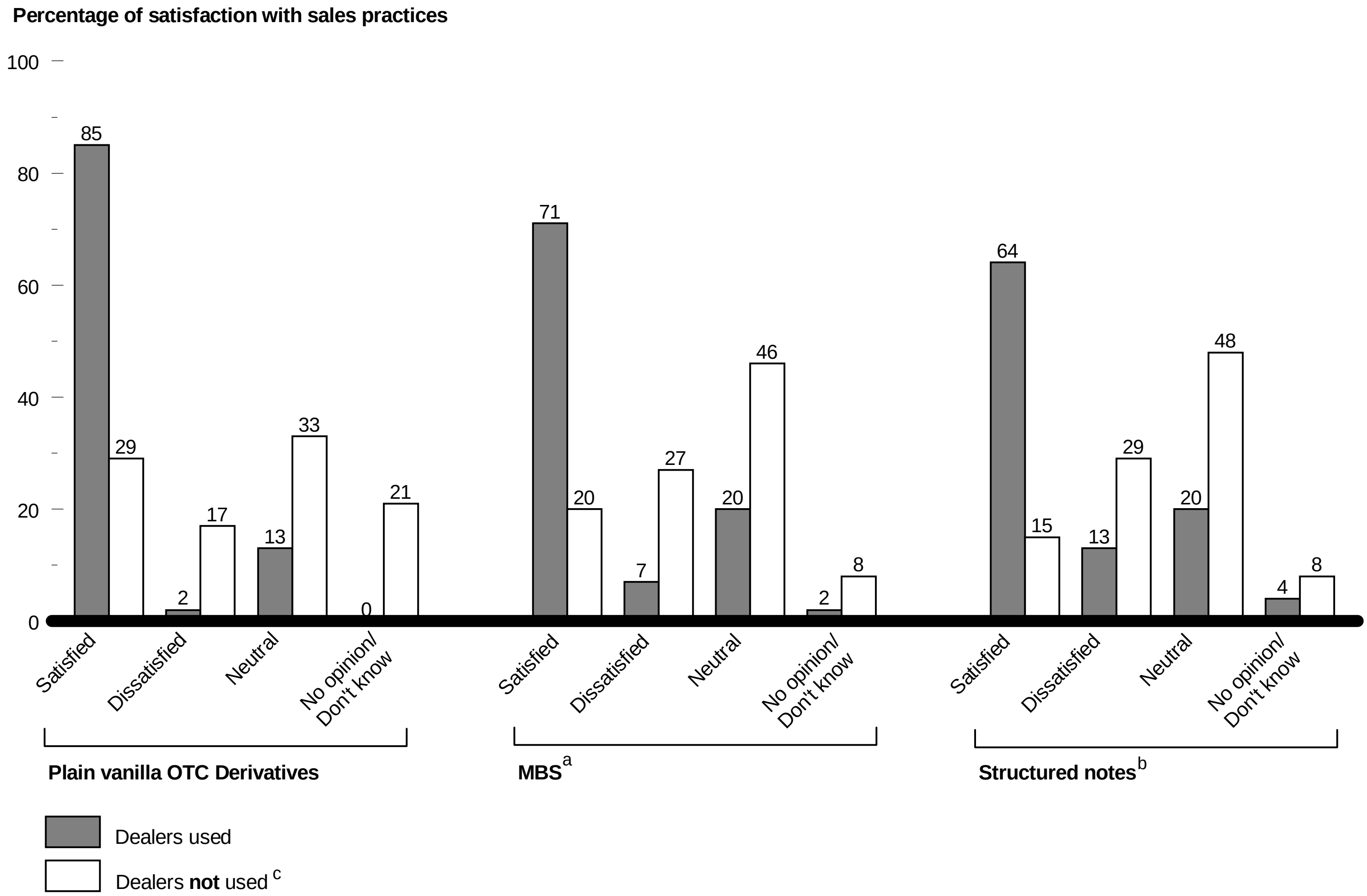
[1]Respondents were also able to indicate that they either "did not know" or had "no opinion."

for transactions involving OTC derivatives, MBS, or structured notes and (2) dealers that made product proposals to them but whom they did not use for a particular product.

As shown in figure 3.1, 2 percent of the organizations across the industries we surveyed reported being "somewhat" or "very dissatisfied" with the overall sales practices of the dealers they used for plain vanilla OTC derivatives contracts. For MBS dealers used, 7 percent[2] of users reported being similarly dissatisfied; for structured note dealers used, 13 percent reported being similarly dissatisfied.

[2]All the population estimates from our survey have sampling errors of plus or minus 10 percentage points, or less, at the 95-percent confidence level, unless otherwise noted. This means that a 95-percent probability exists that if we were to survey all of the organizations in this population, the actual result obtained would fall within a range above and below the estimate cited of no more than the amount of the sampling error for that particular estimate. See appendix I for the exact sampling errors for each estimate in the report and more information about the various errors that may affect survey estimates. For example, survey respondents may intentionally or accidentally misreport their organizations' product usage.

Figure 3.1: Overall Sales Practice Ratings Reported for Dealers Used and Dealers Not Used, by Product



Note 1: The categories of satisfied and dissatisfied in this figure represent the total of those respondents that reported being somewhat or very satisfied or somewhat or very dissatisfied, respectively, with dealers' overall sales practices. The neutral category represents those that reported being neither satisfied nor dissatisfied.

Note 2: Ratings may not add to 100 percent due to rounding.

[a]The satisfaction ratings for dealers used relate to MBS only, but ratings for dealers not used include other asset-backed securities because we were unable to separate out such products from these responses.

[b]The sampling error for the percentage of structured notes users who reported being satisfied (64 percent) was plus or minus 11 percent.

[c]Dealers not used were those that made product proposals to end-users but were not used for a particular product.

Source: GAO survey.

Our survey indicated that 79 percent[3] of the end-users of more complex OTC derivatives were somewhat or very satisfied with the dealers with whom they did business, which was comparable to the levels of satisfaction reported for dealers of the three product types shown in figure 3.1. Because of the small number of end-users of more complex OTC derivatives and the even smaller number who reported being dissatisfied with the dealers they used, we could not make a reliable estimate of the extent of dissatisfaction with overall dealer sales practices for more complex products. Similarly, the small number of end-users reporting dissatisfaction with other products among our survey respondents precluded a statistically valid analysis of dissatisfaction by the size of organization or by industry subgroups.

As shown in figure 3.1, an analysis of our survey results indicated that organizations reported less satisfaction with the overall sales practices of dealers they heard presentations from but with whom they did not do business. The percentages of organizations that were either somewhat or very dissatisfied with the overall sales practices of dealers that they did not use could be at least twice as high as the comparable percentages for dealers that were used.[4] The overall level of dissatisfaction with dealers not used was 17 percent for plain vanilla OTC derivatives, 26 percent for more complex derivatives,[5] 27 percent for MBS and/or asset-backed securities, and 29 percent for structured notes.

Between 4 and 8 percent of the organizations not using a particular product were contacted by at least one dealer offering that product during the survey period. Furthermore, some evidence exists that the extent to which dealers contacted nonusers is somewhat higher than these percentages suggest because some nonusers contacted chose not to rate the dealers' presentations. These respondents reported that they generally did not listen to the dealers' complete presentations or thoroughly

[3]Subject to a plus or minus 19-percent sampling error.

[4]The differences in dissatisfaction levels between dealers used and not used were statistically significant for plain vanilla OTC derivatives and MBS, while the differences for more complex OTC derivatives and structured notes were not statistically significant due to the small numbers of dissatisfied end-users of these products in our sample.

[5]Subject to a plus or minus 12-percent sampling error.

evaluate them because they did not find the products appropriate for their organization or for their investment objectives.

For those end-users and nonusers who rated dealers they did not do business with, the higher level of dissatisfaction reported with the dealers not used suggests that potential end-users may have chosen not to do business with dealers whose sales practices were objectionable or appeared questionable for particular transactions.[6] Comments by some end-users were consistent with this interpretation, as some respondents indicated that they refused to do business with some dealers. Also, some respondents noted that their satisfaction with dealer sales practices varied by product at some dealers or depended on which member of a dealer's sales staff presented a transaction.

Respondents Provided Consistent Reasons for Their Dissatisfaction With Specific Elements of Dealer Sales Practices

Respondents who were dissatisfied with dealer sales practices provided similar reasons for their dissatisfaction with two individual elements of sales practices—disclosure of downside risk and suitability of products proposed.[7] In addition to providing ratings on their overall satisfaction with dealers' sales practices (as shown in fig. 3.1), survey respondents also provided ratings of individual sales practice elements. For disclosure of downside risk, none of the estimates for the rate of dissatisfaction with dealers used exceeded 20 percent for any of the products. End-users of structured notes reported the highest rate of dissatisfaction—17 percent—with thks element. However, for dealers not used, these rates of dissatisfaction were higher. Twenty percent of the organizations in our population reported dissatisfaciton with the risk disclosure practices of dealers not used that offered plain vanilla OTC derivatives, while 38 percent[8] reported dissatisfaction with the risk disclosure practices of dealers not used that offered more complex OTC derivatives. In addition, 27 percent of the organizations reported dissatisfaction with the risk disclosure practices of dealers they had not used for MBS, and 31 percent reported dissatisfaction with the risk disclosure practices of dealers they had not used for structured notes.

[6]In some cases, respondents might have rated the same firm as a dealer used and as a dealer not used because an end-user may have entered into a transaction for a product with a dealer on one occasion but may have chosen not to do so on another occasion.

[7]Because of the relatively few end-users of OTC derivatives that existed and the even fewer number that were dissatisfied, we could not make (1) precise estimates of the extent of dissatisfaction with these two elements of sales practices and (2) any estimates of the extent of dissatisfaction with the other four elements of sales practices that we asked survey respondents to rate.

[8]Subject to a plus or minus 13-percent sampling error.

In follow-up conversations or in their written comments, some respondents explained why they were dissatisfied with dealer risk disclosures. Officials at 19 of the 50 judgmentally selected organizations with which we followed up told us that they were dissatisfied in some way with the amount of information dealers had provided.[9] For example, an official of a money management firm said that risk disclosure was the primary problem with dealer sales practices. For MBS and structured notes, he said that dealers had not provided sufficient information about the reduced market liquidity of some products and that end-users could not rely on commercially available pricing information to determine the market liquidity or prices that could be received for products.

Some officials at these 19 organizations commented that even dealer personnel did not appear to understand the potential downside risks of the products. For example, an official at a mutual fund told us that dealer staff often provided written materials on how product use could be beneficial, but the dealer staff could not always answer questions about how the value of the products would change as interest rates changed. An insurance company official wrote on the survey form that his firm's dissatisfaction rating reflected experiences with some of the smaller dealers that contacted the firm. The official believed that the larger dealers generally did a good job of explaining the merits and risks of products.

According to our survey results for another individual sales practice element that we asked questionnaire recipients to rate, organizations were not always satisfied with the suitability of the products dealers proposed, and this dissatisfaction was again more significant for dealers they did not use.[10] For this particular element, all of our estimates of dissatisfaction with dealers used fell below 10 percent. However, for dealers not used, the estimates of dissatisfaction were higher—18 percent of end-users reported being somewhat or very dissatisfied with the suitability of plain vanilla OTC derivatives proposed by dealers that were not used, while 42 percent[11] reported dissatisfaction with the suitability of more complex OTC derivatives transactions proposed by dealers that were not used. Thirty-six percent reported dissatisfaction with the suitability of MBS that were

[9]We conducted follow-up telephone interviews with 50 judgmentally selected organizations that had responded to the survey—about one-half of which had expressed dissatisfaction and one-half of which were generally satisfied with dealer sales practices. See appendix I for more information on our methodology.

[10]When rating this aspect of dealer sales practices, survey respondents were not asked to rate whether dealers had complied with any legal requirement to determine the suitability of a recommendation.

[11]Subject to a plus or minus 13-percent sampling error.

offered but not purchased, and 39 percent reported dissatisfaction with the suitability of structured notes that were offered but not purchased.

Officials at 16 of the 50 organizations with which we followed up indicated that dealers were not sufficiently considering end-user circumstances when proposing transactions. For example, an official at a money market mutual fund said that, although such funds should maintain fixed net asset values, many of the transactions dealers proposed to his organization were for products that could cause large declines in the value of the fund. A credit union official described mixed experiences. He said some dealers seemed interested in selling a product regardless of the credit union's needs and requirements, but others were more willing to describe products and attempt to understand the organization's needs. Officials of at least three organizations were concerned that dealers were marketing GSE-issued structured notes by portraying them as safe, government-backed investments, even though the values of such products could be quite volatile.

Although some organizations were concerned about the suitability of products that dealers offered, other organizations generally welcomed receiving proposals even if the product was not currently appropriate or suitable for them. For example, officials at a hardware products manufacturer that exported worldwide explained that their firm used OTC derivatives for managing its foreign currency exposures and for altering the mix of fixed and floating interest rate obligations used to finance its operations. Although the firm had specific guidelines related to its use of these products, it was still interested in hearing ideas that could lead to alternative ways of meeting its needs. Similarly, officials at three large multinational firms told us that, even though their firms receive numerous proposals from dealers, they explore only those they considered appropriate for them. However, they appreciated receiving the other proposals so that they could better evaluate their own risk management activities.

Reported Product Usage Varied Across Products and by Organization Size and Type

Our survey revealed that the extent of OTC derivatives, MBS, and structured notes usage varied, with fewer organizations reporting use of OTC derivatives than of MBS and structured notes. In general, larger organizations were more likely than smaller ones to report using any of these products, although smaller organizations were active users in some industries, such as banking. The extent of reported product usage also varied across industries and organizations, with more financial organizations reporting use of the products than nonfinancial organizations, such as state and local governments. Surveys conducted by other organizations covering periods after that of our survey indicated that rates of usage showed little change, with some showing slight declines.

Few Organizations Reported Using OTC Derivatives, More Reported Using MBS and Structured Notes

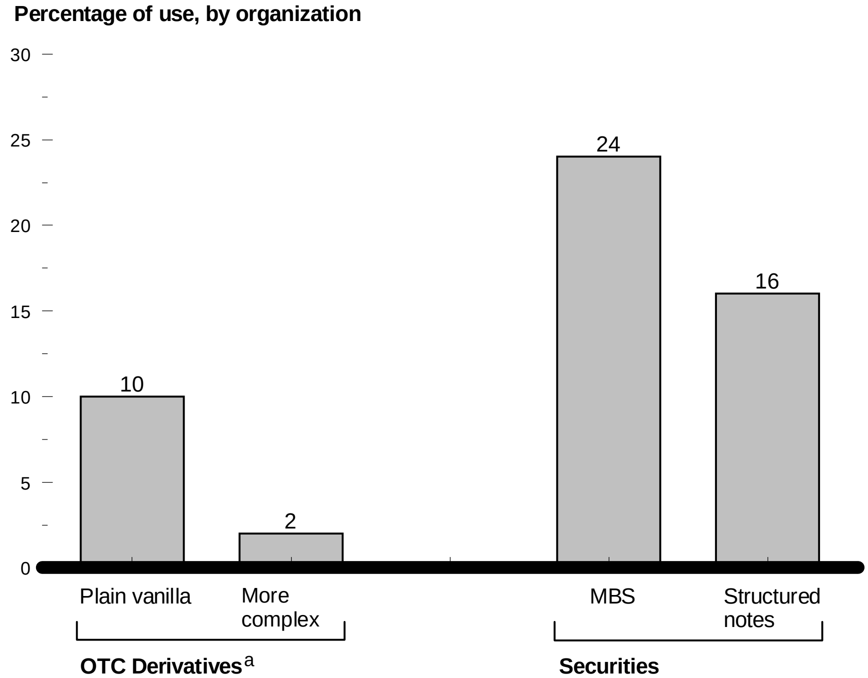
Our end-user survey measured the usage of OTC derivatives, MBS, and structured notes over a broad population of U.S. organizations. The survey results indicated that relatively few public and private organizations used an OTC derivative product, with an estimated 11 percent[12] of such organizations reporting using such a product in the 12 months before our survey was received, beginning for most organizations in the spring of 1995. Some of these organizations had reported using either plain vanilla or more complex OTC derivatives, and others had reported using both. We estimated that in the period defined by our survey, approximately 5,200 end-users of OTC derivatives (plain vanilla, more complex, or both) existed in the population of approximately 49,000 potential end-users from which we drew our sample.[13]

As shown in figure 3.2, 10 percent of these organizations reported using plain vanilla OTC derivatives, and 2 percent reported using more complex OTC derivatives. Reported usage of other products was somewhat more widespread—approximately 24 percent of such organizations reported holding at least one MBS, and 16 percent reported holding at least one structured note during the study period. We estimated the number of end-users for these products to be approximately 11,500 for MBS and 7,700 for structured notes. Although we did not survey individual investors, regulators and exchange officials told us that few individuals used OTC derivatives and their usage of MBS and structured notes was small. For example, NYSE officials estimated that individual investors accounted for about 5 percent of the volume in the MBS market.

[12]Subject to a plus or minus 2-percent sampling error.

[13]See appendix I for a detailed description of how we defined this population and drew our survey sample.

Figure 3.2: Extent of Reported Product Usage Across the Potential User Population



[a]Includes securities OTC derivatives.

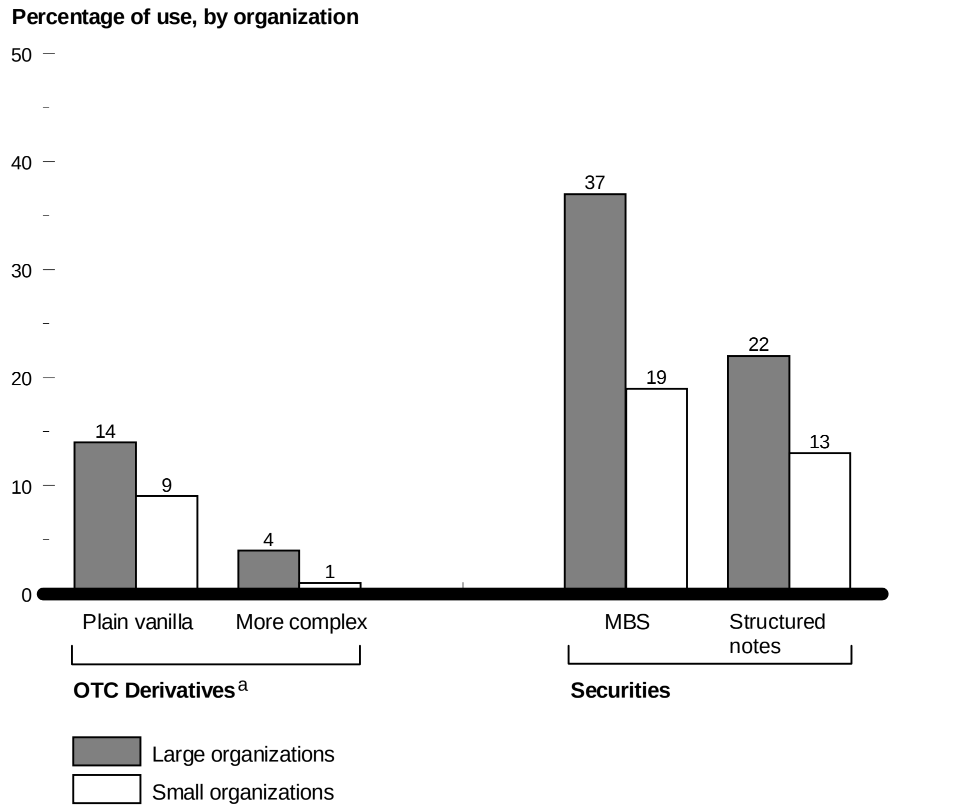
Source: GAO survey.

Larger Organizations Were More Likely to Be End-Users

As shown in figure 3.3, the larger organizations were more likely to indicate that they were users of OTC derivatives, MBS, and structured notes.[14]

[14]We grouped the organizations in each industry into one or more substrata by asset size, investment portfolio size, revenue, sales, population, or other relevant indicators of financial size, depending on the type of industry and the information available. However, for banks and credit unions, we obtained additional information on past usage of certain OTC derivative products and MBS that was used to improve the accuracy of our groupings for these firms, not just in terms of financial size, but also in terms of the likelihood of current product usage. Therefore, the criteria for division between larger and smaller organizations vary across industries, and although the larger subgroups are typically comprised of the top 10 percent of the population, from 1 percent to about 33 percent of some industries may be apportioned to the largest subgroups. See appendix I for a more thorough description of how we defined large and small industry subgroups.

Figure 3.3: Extent of Reported Product Usage, by Organization Size



Note: See appendix I for a description of how we defined large and small organizations across industry strata.

[a]Includes securities OTC derivatives.

Source: GAO survey.

Even though large organizations were more likely to be end-users of these products, some types of small organizations, which were aggregated in the survey analysis because of the small sample sizes involved, reported using MBS at higher rates. For example, small banks, credit unions, and insurance companies—aggregated in the survey analysis because of the small sample sizes involved—reported using MBS at a combined rate of 40 percent,[15] which was about twice the estimated 21-percent usage rate across all

[15]Subject to a plus or minus 11-percent sampling error.

other organizations. In addition, 35 percent[16] of the small bank, credit union, and insurance company subgroup reported using structured notes, while overall 12 percent of all other organizations reported use of such products. Similarly, OCC reported that, as of March 31, 1996, 41 percent of the approximately 8,600 banks with less than $250 million in assets had invested in structured notes that had a total market value of about $6.2 billion. According to OCC, the percentage of small banks using structured notes was equal to that of the other 1,274 banks with assets exceeding $250 million.

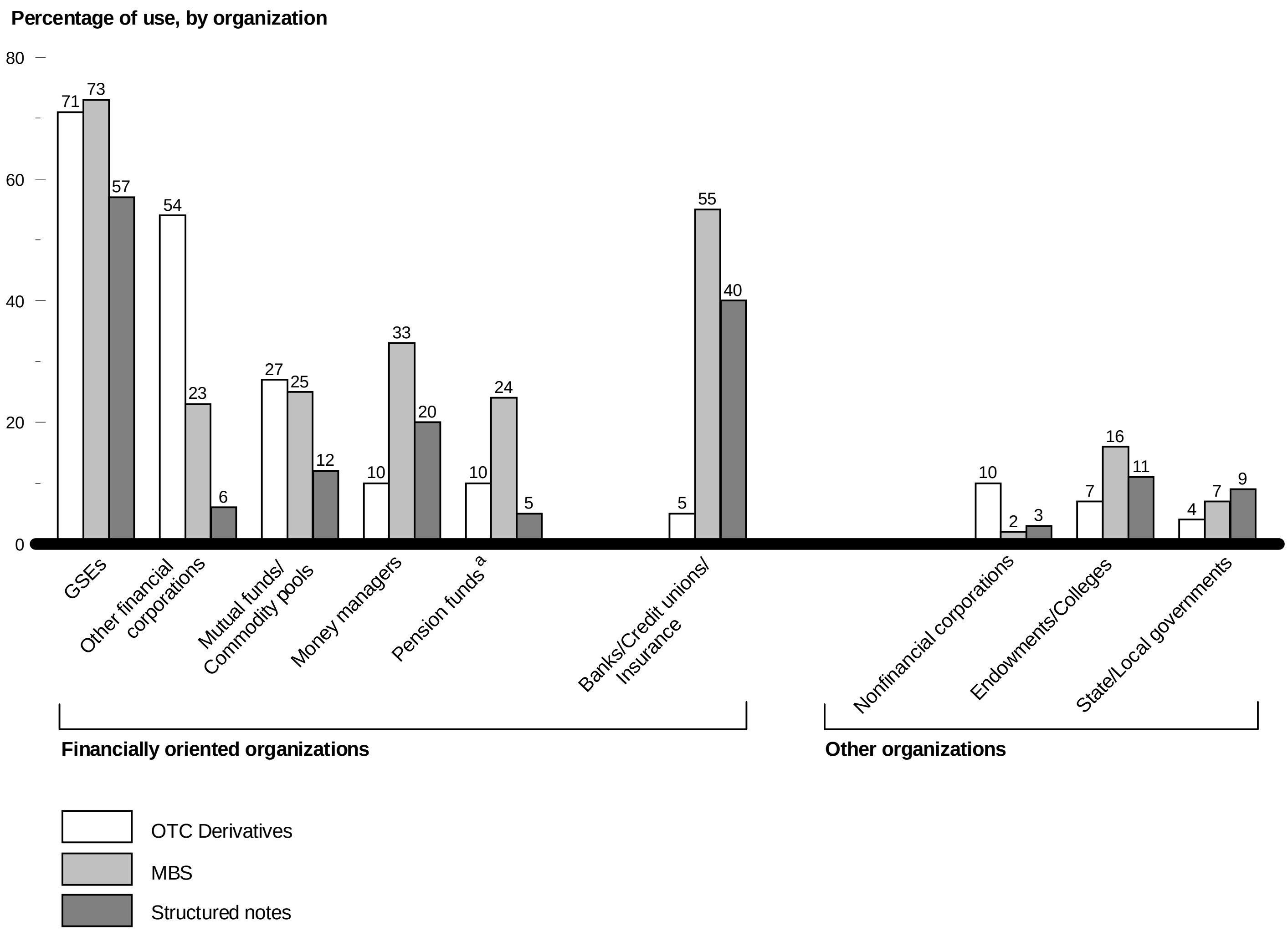
Product Usage Varied by Industry

Our survey results indicated that usage of OTC derivatives, MBS, and structured notes was generally higher among the more specialized and perhaps more sophisticated financial services and investment management industries.[17] As shown in figure 3.4, among the various industries we surveyed, reported use by GSEs indicated that they were the most active users of all three of these product types. On the basis of information provided by the 31 GSEs that responded to our survey, 71 percent of these large and generally financially sophisticated institutions reported using OTC derivatives. About the same percentage also reported using MBS, while 57 percent of GSEs reported using structured notes. A group we classified as "other financial corporations"—which included large credit-financing organizations, mortgage brokers and lenders, and leasing agencies—also reported being active users of OTC derivatives. In contrast, banks, credit unions, and insurance companies reported active use of MBS and structured notes but comparatively less use of OTC derivatives.

[16]Subject to a plus or minus 13-percent sampling error.

[17]Statistics on the rates of usage by all industry substrata are shown in appendix I, tables I.5 through I.8.

Figure 3.4: Extent of Reported Product Usage, by Industry



Note 1: Because of the small number of respondents in some industries, small differences in usage percentages may not be statistically significant.

Note 2: Appendix I describes the organizations that are included in the groupings in this figure.

[a]Pension funds include both private and public (governmental) pension funds.

Source: GAO survey.

In addition, the survey results from the pension fund industry indicated differing levels of usage within certain subgroups. Although the average usage rates reported across the overall universe of large and small public and private pension funds were not above average, the large public pension fund subgroup reported relatively higher usage rates. Forty-one percent of the large public pension funds reported using plain vanilla OTC derivatives, 33 percent reported using structured notes, and 74 percent reported using MBS.

Our survey also showed that nonfinancial corporations (service and manufacturing firms), endowments and colleges, and state and local governmental entities[18] did not make extensive use of any of the products. Among nonfinancial corporations, overall reported usage rates were average or below average for all of the products. However, the "larger organization" subgroup of nonfinancial corporations[19] did report using plain vanilla OTC derivatives to a great extent. We estimated that 66 percent[20] of the population of large U.S. nonfinancial firms used plain vanilla OTC derivatives during the survey period. This estimate is comparable to those of other surveys of similar organizations, many of which reported usage rates of over 50 percent.

Although higher proportions of firms in the specialized, sophisticated financial industries may be using OTC derivatives, MBS, and structured notes, they often represented a smaller total number compared to the actual number of reported end-users among some of the more populous nonfinancial industries. For example, even though 71 percent of GSEs reported using OTC derivatives, they made up less than 1 percent of the entire number of estimated end-users. However, nonfinancial corporations made up an estimated 22 percent of the total population of end-users of OTC derivatives, even though only 10 percent of the firms in this industry grouping reported using these products. Similarly, while 27 percent of the aggregated industry group of mutual funds, money market funds, and commodity pools reported using OTC derivatives, the number of such organizations represented 39 percent of the total number of end-users for this product type.

[18]Local governmental entities included state treasuries, local school districts, special districts, cities, and counties (see app. I, table I.2).

[19]For publicly held corporations, we drew our sample of large organizations from the top 10 percent (annual sales over $1.4 million) of our population of approximately 5,600 firms. For privately held nonfinancial corporations, we designated the top 200 firms on the basis of their assets (2.5 percent of our universe of 8,000) as large corporations.

[20]Subject to a plus or minus 12-percent sampling error.

More Recent Studies Generally Showed Little Change in Product Usage

A number of publicly reported studies conducted after our survey generally showed either no change or slight declines in the proportion of organizations in various industries that use OTC and other derivatives. To assess the magnitude and direction of any change in usage that may have taken place after our survey closed in October of 1995, we reviewed studies conducted by three external organizations that measured usage among specific industries over a period extending to October 1995 or beyond.[21] Two of the three studies concluded that a slight decrease in derivative product usage had occurred among certain organizations after 1995. A series of surveys conducted by Greenwich Associates estimated that 68 percent of a selected sample of public and private nonfinancial corporations used derivatives in 1995, while 59 percent of such corporations used derivatives in 1996.[22] The Greenwich Associates' surveys suggest that for nonfinancial corporations, usage reached a high point in 1995, after having increased somewhat in the preceding years. Surveys of public and private pension plans conducted for the September 1995 and March 1997 issues of Institutional Investor Magazine concluded that derivatives usage had declined from 52 percent to 48 percent.[23] However, another set of surveys of publicly held U.S. nonfinancial corporations in 1994 and 1995 found an increase in the proportion of derivative product users. The Wharton School of Business estimated that 41 percent of these organizations used derivatives in October 1995, an increase from November 1994.[24]

[21]Although we attempted to confirm that the industry populations surveyed and products specified in these other studies were generally similar to those discussed in this report, the estimates of usage from these other studies are usually not directly comparable to those from our survey because of the variability of the samples selected and questions asked. Most of the recent studies we reviewed rely on small, nonprobability convenience samples that usually represent a self-selected subset of only the larger organizations within any particular industry. We did not assess the quality or verify the results of any of these external studies.

[22]North American Treasury Services, 1996 Report, Greenwich Associates (Greenwich, CT: July 1996). This survey obtained 588 personal interviews with senior treasury managers at a judgmental sample of multinational corporations, large domestic companies, foreign subsidiaries, regional banks, and government agencies in May through July of 1995 and 457 interviews in May through July of 1996.

[23]"Pensionforum Survey," Institutional Investor Magazine (New York, NY: Sept. 1995 and Mar. 1997). This survey received an unknown number of responses from a judgmental sample survey of 800 corporate and 250 public pension plan sponsors, conducted quarterly.

[24]1995 Survey of Derivatives Usage By U.S. Non-Financial Firms, Wharton School of Business/Canadian Imperial Bank of Commerce/Wood Gundy (Philadelphia, PA: Apr. 1996). This survey received 530 responses in 1994 and 350 in 1995 from a sample of over 2,000 U.S. nonfinancial firms listed on Standard & Poor's Compustat database. The 1995 sample also included an undetermined number of additional Fortune 500 firms that had not been included in the 1994 sample.

Sales Practice Concerns Did Not Appear to Be Widespread but Involved Many Large Losses

Concerns about dealer sales practices have been raised in many of the publicized losses incurred by end-users of OTC derivatives, MBS, and structured notes. Although many of the losses were large, sales practice concerns related to OTC derivatives involved primarily one dealer. More sales practice concerns were raised for transactions involving MBS and structured notes. However, such losses involved a relatively limited number of dealers.

Concerns About Dealer Sales Practices Were Raised in Many Publicized Losses

Combining publicly available information and regulatory data, we compiled a list of U.S. and foreign end-users that experienced losses from OTC derivatives, MBS, or structured note transactions with U.S. dealers.[25] From this list and with the information used to compile it, we identified losses in which sales practice concerns were raised by end-users or regulators. Through this effort, we identified 360 end-user losses involving OTC derivatives, MBS, and structured notes, with the earliest loss occurring in April 1987 and the latest loss occurring in March 1997.[26] These end-user losses totaled an estimated $11.4 billion. Sales practice concerns were raised in 209, or 58 percent,[27] of these losses and were associated with an estimated $3.2 billion in losses. However, since many disputes were associated with a relatively limited number of dealers, and given the many thousands of transactions in OTC derivatives, MBS, and structured notes and the hundreds of billions of dollars at risk in these transactions over the

[25]Our list of end-user losses was compiled from publicly available information and regulatory data. To identify losses, we conducted searches of periodicals, industry publications, special studies, and litigation reporting service data. We also reviewed regulatory case data and discussed such cases and related matters with banking, securities, and futures regulators. We limited our list to end-user losses directly involving OTC derivatives (forwards, options, and swaps), MBS, or structured notes. We excluded losses that dealers incurred and that foreign end-users transacting with foreign dealers incurred. We also excluded derivatives-related losses involving the sale of mutual funds or OTC contracts that CFTC or a court found to be illegal, off-exchange futures contracts. Although many of the losses are supported by multiple sources, we generally did not confirm the accuracy of the information provided by such sources.

[26]The number of losses and the total amount of losses may be overstated by including losses involving products not covered in this report and unrealized losses. The number of losses and the total amount of losses may also be understated to the extent that all losses were not publicly reported. In this regard, we have included in the number of losses instances where the entity was reported as having a loss, even when the loss amount was not reported and, therefore, could not be included in the total loss amount.

[27]This percentage, as with similar percentages reported in this section, is not a statistically valid estimate of the actual extent to which sales practice concerns have been raised in connection with OTC derivatives, MBS, and structured note transactions. It is based on a compilation of losses that is not necessarily representative of the population of transactions involving OTC derivatives, MBS, and structured notes.

period we reviewed,[28] we found that sales practice concerns were not widespread.

As indicated above, not all OTC derivatives, MBS, and structured note losses involved sales practice disputes. For example, 42 percent of the publicly reported losses were not accompanied by sales practice disputes, and for OTC derivatives, 59 percent of the reported losses were not associated with such disputes. End-users that incurred losses may not have raised sales practice concerns if the products were used to hedge other positions that had offsetting gains. EUDA confirmed that some end-users suffering large derivatives losses had been using the products as hedges. In such instances, the losses were not unexpected because the derivatives operated as anticipated and were offset by gains in the underlying hedged items. Alternatively, when derivatives performed differently than the way the dealer had represented they would perform, EUDA said disputes have arisen.

OTC Derivatives Losses With Sales Practice Concerns Involved Primarily One Dealer

Our review identified 44 end-user losses that involved OTC derivatives transactions with U.S. dealers. These losses totaled an estimated $5.4 billion. Sales practice concerns were raised in 18 of these losses, accounting for about 41 percent of the total OTC derivatives losses and covering an estimated $1.7 billion in losses. The losses with sales practice concerns involved 9 dealers; however 1 dealer, Bankers Trust, was involved in 9 of the 18 end-user losses.

Sales practice allegations against Bankers Trust have been among the most widely publicized and have resulted in lawsuits and regulatory action. As noted in our 1994 report on OTC derivatives, Bankers Trust is a major U.S. OTC derivatives dealer,[29] and it had a reputation for offering some of the most sophisticated derivatives products. In April 1994, two of its customers, Procter & Gamble and Gibson Greetings, Inc., announced that they faced losses on certain complex OTC derivatives transactions with Bankers Trust. Procter & Gamble announced after-tax losses of about $102 million on two complex swaps transactions, and Gibson Greetings reported after-tax losses of almost $20 million in a series of complex swaps and options transactions. Both corporations, as well as several other Bankers Trust customers that suffered losses, filed suit against

[28]According to the Federal Reserve, the amount at risk, as measured by the gross market value of OTC derivatives outstanding, was $328 billion for U.S. entities, as of March 1995, or about 3 percent of the notional/contract amount.

[29]See GAO/GGD-94-133.

Bankers Trust alleging, among other things, fraudulent sales practices. As discussed on page 78, Bankers Trust has settled with Procter & Gamble and Gibson Greetings as well as with other customers.

SEC, CFTC, and the Federal Reserve investigated Bankers Trust's conduct, and each regulator reached a settlement or similar agreement with Bankers Trust (the SEC and CFTC actions were discussed in ch. 2, and the Federal Reserve's action is discussed in ch. 6). In December 1994, SEC and CFTC concluded their investigations with a joint settlement addressing Bankers Trust's dealings with Gibson Greetings. Without admitting or denying SEC's and CFTC's findings, Bankers Trust agreed to the issuance of SEC and CFTC orders finding that the bank violated antifraud provisions of the federal securities and commodities laws and agreed to pay a $10 million fine. During the same period, the Federal Reserve entered into an agreement with Bankers Trust that required it to establish, among other things, new marketing and sales practice policies that were consistent with safe and sound banking practices.

The eight dealers involved in the remaining nine end-user losses with sales practice concerns were largely major U.S. securities firms;[30] however, unlike the losses associated with Bankers Trust, these losses generally involved instances where only one end-user had raised concerns about a dealer's conduct. The end-users incurring the losses were foreign firms, individuals, and a state, and their losses ranged from an estimated $8 million to $371 million. In these losses, many of which involved lawsuits, the end-users alleged, among other things, that the dealers had misrepresented the risks of the products or induced the end-user to enter into unsuitable or unauthorized derivatives transactions.

Regulatory staff at SEC, NASD, and NYSE told us that they have received few, if any, other complaints against securities firms involving OTC derivatives. Notwithstanding the limited number of complaints and publicized OTC derivatives losses involving sales practice concerns, the extent to which such concerns exist may not be fully apparent. Speaking at an industry conference, an OCC official said that the agency's examiners identified instances in which banks agreed to settle certain OTC derivatives transactions for less than the amounts due after their customers expressed concerns about the practices that the banks used to market the products. The OCC official was not able to estimate the total number of such occurrences or the dollar amounts involved. Furthermore, an official from

[30]According to press accounts and other sources, five of these cases have been settled and the other four cases are ongoing.

a financial markets consulting firm also indicated that some of its clients have settled transactions for amounts less than due under circumstances similar to those described by the OCC official. In addition, EUDA expressed the view that more sales practice disputes between end-users and dealers have arisen than were aired publicly, many of which it said probably involved modest losses.

More Sales Practice Concerns Were Raised in MBS and Structured Note Transactions, but Such Concerns Generally Involved Few Dealers

MBS and structured notes were used more often than OTC derivatives, and a greater number of sales practice concerns were raised with these products than with OTC derivatives. Our review identified 285 end-user losses connected with MBS and/or structured note transactions. These losses totaled an estimated $5.6 billion. Sales practice concerns were raised in 190 of these losses, accounting for 67 percent of the total losses and covering an estimated $1.6 billion. The losses associated with sales practice concerns involved 56 dealers, ranging from major national securities firms to smaller regional firms. However, 8 dealers were involved in 148 of these losses. According to press accounts and similar articles, common sales practice allegations included the dealers misrepresenting the risks of the products and/or omitting material information about them.

Our review of regulatory efforts to enforce securities laws applicable to MBS and structured notes also indicated that cases in which sales practice concerns were raised involved a limited number of firms, with an even smaller number of firms accounting for large numbers of disputes with individual end-users. To assess the extent to which sales practice concerns were associated with MBS or structured note transactions, we collected data on investigations by securities regulators and on complaints these organizations received in the 4-year period from January 1993 through December 1996. The regulatory organizations included were SEC, NASD, and NYSE.[31] In total, we found that these organizations had conducted 55 dealer investigations during this 4-year period. However, some of these investigations involved several personnel at individual firms, and some dealers had been investigated by more than one regulator. Table 3.1 summarizes the status of these investigations.

[31]As discussed in chapter 2, NASD and NYSE together oversee most of the securities firms marketing MBS or structured notes in the United States.

Table 3.1: Status of Investigations of Dealers by SEC, NASD, and NYSE From 1993 Through 1996 for Cases Involving MBS and Structured Notes

	Number of dealers		
Investigation status	**SEC**	**NASD**	**NYSE**
Dealers still under investigation	10	6	4
Dealer investigations resulting in formal sanctions against a firm or selected personnel	0	6	8
Cases closed with no action taken	9	3	2
Cases not pursued:			
Dealer out of business (e.g., bankrupt)	1	0	0
Case referred to another regulator	0	1	1
Dealers investigated for nonsales practice violations instead	4	0	0
Total of cases not pursued	**5**	**1**	**1**
Total	**24**	**16**	**15**

Note: Forty-four dealers were subject to investigation by these regulators during this period. The table totals to 55 as some dealers were being investigated by more than 1 regulator.

Sources: GAO analysis of data from SEC, NASD, and NYSE.

Overall, SEC, NASD, and NYSE investigated a total of 44 different dealers. However, just a few firms accounted for a large number of the losses in which individual end-users had raised sales practice concerns. For example, 6 Houston firms were being investigated or considered for investigation across more than 78 end-users. SEC and NASD staff were investigating 1 of these dealers for its dealings with as many as 30 customers in several states. This firm consented to a regulatory settlement, stating that it had committed various sales practice-related violations, including making material misrepresentations of MBS risks, failing to adequately supervise its sales representatives, and lacking procedures to ensure that product risks were disclosed to end-users. SEC was also investigating at least 3 other dealers for activities involving numerous end-users, ranging from 10 to 23 end-users at each firm.

Typically, these cases involved dealers marketing GSE-issued MBS, including some of the more volatile variations, to municipal and county governments and colleges. For example, an end-user in one of these cases—City Colleges of Chicago—had estimated losses of around $38 million, as of March 1996, after purchasing about $110 million in volatile MBS from one dealer. In at least two of the cases that SEC or the SRO staff were investigating, the end-users had accused dealer personnel of marketing high-risk securities by characterizing them as safe, federally insured investments.

Although the bulk of these cases involved a few smaller securities firms, some of the largest securities firms were involved in the MBS case that had the largest loss. In this case, Askin Capital Management, a New York-based investment management firm, reportedly lost over $660 million after the declines it experienced from adverse market movements led to the April 1994 liquidation of several funds it managed. These funds had been invested in some of the most volatile CMO tranches. Some of the fund investors sued Askin Capital Management and at least three large securities firms that sold Askin the volatile products.[32] The investors alleged that Askin promised them high returns without large risks, but instead purchased high risk securities. The suit claims that the three large securities dealers abetted Askin in these fraudulent sales because they needed Askin and others to buy the higher risk CMO tranches before the lower risk tranches could also be sold, thereby ensuring the profitability of the entire issuance of securities.

Other than these cases, regulators reported that a limited number of allegations of deficient dealer sales practices involving MBS and structured notes were identified. Table 3.2 shows the number of complaints received by securities industry regulatory bodies from 1993 through 1996 for MBS. These data indicate that the total complaints involving MBS was about 1 percent of the total number of complaints received. These regulatory bodies did not separately track complaints, if any, they had received involving structured notes.

Table 3.2: Complaints Received by Regulators From 1993 Through 1996 Involving MBS Sales Practices and Total Complaints for All Products

	Complaints involving MBS sales practices					Total complaints for all products
Regulator	1993	1994	1995	1996	Total	(1993-1996)[a]
SEC	42	112	50	30	**234**	49,869
NASD	51	69	57	29	**206**	18,345
NYSE	71	300	405	122	**898**	3,984

[a]Includes all products for which these regulators received complaints (including stocks, corporate bonds, etc.). The volume of stocks, bonds, and other products being traded likely exceeds the volumes attributable to MBS, but we did not attempt to standardize complaint information, such as by calculating the ratio of complaints to volume traded, across products due to the lack of data on trading volumes for all products.

Source: GAO analysis of data from NASD, NYSE, and SEC.

The bulk of the sales practice cases being reviewed by regulators involved MBS; however, one case involving structured notes has been widely

[32]The three large securities dealers were Kidder Peabody; Bear Stearns; and Donaldson, Lufkin & Jenrette.

reported by the press. In 1994, Orange County, CA, filed for bankruptcy after incurring over $1.7 billion in losses in its investment portfolio that included GSE-issued structured notes. While about $970 million of the losses were attributed to structured notes, the county had also used other nonderivative products and had borrowed heavily to make additional investments. Alleging deficient sales practices, the county filed suit against two dealers—Merrill Lynch and Morgan Stanley—that sold it structured notes. Other cases involving losses on structured notes have been made public, but they did not involve allegations of deficient sales practices.

When They Occurred, Sales Practice-Related Disputes Were Often Costly to Dealers and End-Users

Transactions in OTC derivatives, MBS, and structured notes can present significant risks to dealers and end-users. In addition to the familiar risks arising from adverse market movements or counterparty default, dealers with inadequate sales practices expose themselves to significant compliance and reputation risks. We found that, in the recent losses involving sales practice disputes, the associated dealers and end-users frequently experienced significant costs related to these risks.

Compliance and Reputation Risk Losses Can Arise From Sales Activities

Although the potential for OTC derivatives and related financial products to produce losses from adverse market movements or counterparty default has been widely discussed, parties to transactions in these products are also subject to losses arising from compliance and reputation risks. These risks are defined by OCC in December 1995 guidance and appear to aptly describe the various potential losses and costs that can arise from sales practice disputes.[33] OCC describes compliance risk as the potential for losses that result when an entity violates or does not comply with existing laws, rules, regulations, prescribed practices, or ethical standards. The OCC guidance also indicates that this risk is present when the laws or rules governing certain products or customer activities are ambiguous or untested—the situation that seems to have applied to the rapidly growing markets for OTC derivatives. The actual types of losses that result from the failure to adequately manage activities posing compliance risk include regulatory fines, civil lawsuit penalties and damages, legal fees, and voided contracts.

Entities entering transactions in OTC derivatives, MBS, and structured notes without sound sales practices or adequate controls also subject themselves to a second major risk—reputation risk. OCC defines this risk as the potential for reduced earnings and firm value when negative public

[33]Comptroller's Handbook: Large Bank Supervision—Bank Supervision and Examination Process, OCC (Washington, D.C.: Dec. 1995).

opinion affects an institution's ability to establish new customer relationships or maintain existing ones. Such losses can also arise if the shareholders of a public corporation or the investors in an investment company or mutual fund file suit or reduce their investments in the affected institution.

Some Dealers Experienced Significant Costs Associated With Sales Practice Disputes

The Bankers Trust case exemplifies the serious compliance and reputation risks that deficient marketing of OTC derivatives, MBS, and structured notes can pose. Bankers Trust's OTC derivatives sales practice disputes have already resulted in significant costs, and additional compliance and reputation risk losses are possible. Regarding compliance risk, press accounts reported that Bankers Trust forgave as much as $150 million of the amount owed to it by Procter & Gamble and forgave $14 million of the amount owed to it by Gibson Greetings to settle these customers' suits. Bankers Trust also settled with several other firms. In addition, it was required to pay a $10 million fine to settle a joint SEC and CFTC investigation of its dealings with Gibson Greetings and retain an independent consultant to review and make recommendations concerning its OTC derivatives activities. Overall, Bankers Trust reserved $423 million to absorb losses and other payments relating to these derivative-related disputes. Press accounts also indicated that Bankers Trust faced litigation with at least one other derivatives customer—an Italian publishing firm that reported losses on derivatives transactions with the bank in 1994. Furthermore, Bankers Trust has likely incurred significant legal expenses in defending itself against these and other lawsuits, including one by a shareholder.

In addition to these costs, Bankers Trust experienced effects on its reputation or operations that are more difficult to directly measure. It reported sharply lower revenues and profits for 1994—the year the disputes came to light, and its stock price declined around the time its customers were announcing losses. Analysts attributed much of this reduced performance to Bankers Trust's ongoing derivatives problems. Also, according to press reports, Bankers Trust's credit rating was downgraded by the major credit rating services, which was expected to increase its future borrowing costs. Finally, Bankers Trust's chairman resigned and was replaced by an executive from outside of the company.

Another major dealer—Merrill Lynch—was sued by Orange County. The county alleged that Merrill Lynch employed deficient sales practices in marketing structured notes and other financial products and has sought over $2 billion in civil damages. In June 1997, without admitting wrongdoing, Merrill Lynch agreed to pay Orange County $27 million and to reimburse the county and California $3 million to end a criminal probe into the firm's role in the county's bankruptcy. Under the agreement, Merrill Lynch will also implement changes in its procedures and training. The agreement will not affect the county's $2 billion civil damage lawsuit against Merrill Lynch. The county also filed suit against a second major securities dealer—Morgan Stanley—from whom it purchased structured notes. Since initiating an investigation of this case, SEC has taken action against the county's treasurer and assistant treasurer.

As of June 6, 1997, SEC had not taken action against any of the dealers involved for their conduct in marketing structured notes to Orange County, and SEC officials advised us they do not discuss ongoing investigations.[34] However, a press account indicated that some Merrill Lynch staff had earlier raised concerns with its management about the potential risks involved with both marketing securities to and underwriting the debt of Orange County, but that management had not adequately addressed these concerns. If so, Merrill Lynch may have failed to adequately consider the potentially serious compliance and reputation risks of its sales practices and other dealings with Orange County.

A number of other dealers also face potential regulatory action or are involved in litigation as a result of their sales of MBS and structured notes. For example, Askin Capital's loss of as much as $660 million on MBS in 1994 resulted in an SEC investigation of its fund's activities and of the dealers that sold it these investments. As previously discussed, investors in its funds have also filed suit against these dealers in a New York state court. These investors are seeking almost $700 million in restitution and an additional $1 billion for damages from each of the three dealers named in the suit.

Some smaller securities firms have also incurred and continue to face additional costs from their dealings in MBS and structured notes. As previously indicated, as many as 44 dealers are being investigated by regulators for their sales of MBS and some have already been assessed monetary sanctions by federal and state securities regulators or their designated SRO. For example, Westcap Securities of Houston, TX, entered into a consent settlement with SEC in February 1996 in which SEC found that sales representatives had made false or misleading statements to

[34]However, SEC has filed complaints against one securities firm—CS First Boston—and two individuals employed by that firm for their role in underwriting the debt securities Orange County used to fund its investment portfolio. These complaints allege that the financial condition of the county at the time of these issuances was not adequately disclosed to investors in these securities.

customers in marketing CMOs and had excessively traded customer accounts to maximize sales commissions. SEC found that supervision of sales personnel had been deficient. SEC revoked the firm's registration as a broker-dealer and ordered it to pay over $800,000 in regulatory penalties and customer restitution. The firm declared bankruptcy in April 1996.

Other smaller securities firms under regulatory investigation also incurred additional losses and costs as a result of their sales practice-related problems. For example, another Houston securities firm—Government Securities Corporation—was fined $400,000 by NASD and has paid more than $11 million in restitution and other costs as part of its activities with over 30 local government and other public fund customers. The firm was also suspended from selling certain securities to such customers for 2 years. Other end-user suits against dealers included one involving Escambia County, FL, which sued in U.S. district court four of the dealers that sold it volatile MBS that had declined in value by $21 million. In another action, Odessa College of Texas settled legal proceedings under terms that were not publicly disclosed against four dealers that had sold it similar securities.

Some End-Users Also Experienced Significant Costs From Sales Practice Disputes

In addition to the losses that end-users suffered when adverse market movements reduced the value of their OTC derivatives, MBS, and structured note holdings, some end-users have experienced additional costs and losses similar to the compliance and reputation risk losses incurred by dealers. The widely publicized case of Orange County is a primary illustration of the additional adverse financial impacts that an end-user can experience beyond the original investment loss.

In December 1994, the county filed for bankruptcy—the largest reported occurrence of a governmental insolvency in the United States, according to a 1995 statement to Congress by the SEC Chairman—as a result of losses on the portfolio of investments it managed for itself and 187 other local government participants. As indicated in the Chairman's statement, the subsequent liquidation of this portfolio produced at least a $1.7 billion loss.[35] His statement also elaborates that, as a result of the bankruptcy filing, two major rating services downgraded Orange County's debt to speculative grade status.

[35]Although $1.7 billion was initially reported as the amount of the loss, some estimates indicated that total losses exceeded $2 billion.

According to information reported by one of the rating services, when the county issued $275 million in 30-year bonds in June 1995, it paid $10 million to buy insurance guaranteeing repayment—4 times the normal rate for such issues—and an additional .25 percent in interest to investors. Later that same month, the county issued an additional $155 million in bonds; this issuance carried interest payments that were more than 1 percent above comparably rated municipal bonds, according to this rating service account. We calculated that the higher rates of interest paid on these bond issues mean that the county will pay as much as $2.2 million more in interest each year that these bonds are outstanding.

According to testimony by an Orange County official, the county also laid off employees, reduced its operating budget, and is using revenue from other sources to pay off its debt. This official stated that various other California municipalities and public entities also made service cutbacks and reduced planned expenditures as a result of the losses incurred on the funds they invested with the county.

The experiences of other end-users that incurred investment losses and had subsequent sales practice disputes also illustrate the potential for additional compliance and reputation risk losses. For example, both City Colleges of Chicago and Odessa College of Texas have faced additional financial impacts beyond their initial losses on MBS investments. According to a City Colleges' official, the college reduced services and borrowed additional money to cover its liquidity problem. Similarly, Odessa College officials indicated that their MBS losses were a contributing factor in raising student tuition, borrowing from reserves, and restructuring the college's debt.

The case of Gibson Greetings illustrates other compliance and reputation risk impacts. After announcing losses on various derivatives transactions with Bankers Trust, Gibson Greetings was investigated by and subsequently settled the proceeding with SEC for filing financial statements that materially misstated its derivatives positions. Although SEC did not assess a monetary penalty, the regulator ordered the company to cease and desist any additional violation of reporting and recordkeeping, which will likely require that it improve its internal controls and accounting practices for such products. Gibson Greetings also faced at least four shareholder lawsuits that claimed that the company's disclosures about its derivatives activities and other operations were misleading.

Disagreement Over Counterparty Responsibilities Increases the Potential for Disputes

Some end-user losses involving OTC derivatives, MBS, and structured notes have been accompanied by disputes over counterparty responsibilities that reflect differences in dealer and end-user views on the nature of their relationship. These differences in views could contribute to costly sales practice disputes when end-users incur losses. However, reconciling these differences could be difficult given the reaction of end-users to aspects of dealer-issued guidance that address the nature of counterparty relationships. Also, decisions about the specific responsibilities of end-users and dealers can affect the costs of the transaction to each party. In addition to the dealer-issued guidance, steps taken by other dealer groups as well as judicial decisions related to sales practice issues have not completely resolved the differences in end-user and dealer views. As a result, some market participants have indicated that the involvement of federal financial market regulators may be useful.

Disputes Have Centered on Counterparty Responsibilities

Some of the widely publicized losses on OTC derivatives, MBS, and structured notes have resulted in disputes between the end-users and dealers involved over the specific roles and responsibilities that each envisioned for the other, including whether a fiduciary relationship existed.[1] An institution acting as a fiduciary to an end-user, whether established by law or fact, must act in good faith and with loyalty and honesty towards the end-user and disclose to the end-user all material facts relevant to actions it takes within the context of the fiduciary relationship. In one lawsuit, Procter & Gamble accused Bankers Trust of misusing the trust and confidence it had placed in the bank by inducing the firm to enter into swaps that were represented as being safe investments, when instead the transactions entailed considerable undisclosed risk. Bankers Trust countered that it acted solely as a principal by dealing with and not on behalf of Procter & Gamble—that is, by dealing with the firm on an arm's-length basis. The bank also indicated that Procter & Gamble, as with other counterparties, was responsible for making its own assessment of the likely rewards and risks of the transactions, although the bank contended that it had responded to any questions posed and had provided reasonable and accurate information. The resolution of this case is discussed on pages 102 and 103.

[1]In general, a fiduciary relationship is a relationship in which one party owes a duty of trust, loyalty, and confidence to another. These relationships include, but are not limited to, those specifically imposed by law. The party that owes the duty of trust, loyalty, and confidence is a fiduciary and thus may not deal at arm's length (or on equal terms) with the other party but has a duty to provide full disclosure of all relevant facts about transactions, including any financial benefits it receives. A fiduciary's loyalty must be undivided in that it has a duty not to act on behalf of a competitor and not to advance self-interests at the expense of the other party. A fiduciary is entitled to compensation for duties performed unless it is waived by prior agreement.

In another publicized case, the treasurer of Orange County asserted that he relied on the advice of various large securities firms when purchasing structured notes that later incurred losses and contributed to the county's bankruptcy. The dealers denied having any advisory responsibilities and stated that county officials had responsibility for the investments they made. The lawsuit brought against various large securities firms over their dealings in MBS with Askin Capital (see discussion in ch. 3) also alleged that the dealers had breached their fiduciary responsibilities and failed to act in the interests of Askin's investors. In January 1997, the judge in this case reduced the counts against these firms to those pertaining to fraud, according to press accounts.

As these cases indicate, determining whether a formal fiduciary relationship exists can be difficult. In some instances, fiduciary duties are clearly placed on a financial institution by law when the institution agrees to act as an agent in performing certain services. Such fiduciary duties arise, for example, when a bank's trust department manages the assets of an estate or when an investment advisor manages the investments of a pension fund. In other instances, courts have found fiduciary duties applied to a financial institution that had not formally agreed to provide fiduciary services, but whose past relationship with a customer showed a pattern of reliance by the customer on the institution's advice. The factors that courts have considered to establish such a pattern of reliance include the extent to which a customer followed the institution's recommendations, statements by the customer indicating reliance or dependence on the institution, and the customer's general level of sophistication. Generally, courts have ruled that the larger and more sophisticated the customer, the greater its responsibility to independently assess the value and risks of a transaction and the lesser the dealer's responsibility to determine the suitability of a security and to fully disclose product risks and valuations. No specific standards distinguish between sophisticated and unsophisticated customers or degrees of sophistication.

Even when no special relationship exists between a financial institution and an end-user, the institution may have an obligation to disclose to the end-user information regarding a transaction about which it has superior knowledge. Under principles defining common law fraud, superior knowledge or access to the means of knowledge can give rise to an affirmative duty to disclose material information, particularly when the information is not within reasonable reach of the other party. Applying this principle to the securities markets, federal courts have held that securities firms have a special duty not to take advantage of customers' lack of knowledge and, therefore, firms must disclose certain material information—such as the amount of the markup they are charging—even when executing a transaction on a principal-to-principal basis.

The Potential for Additional Disputes Arises From the Differing Views of End-Users and Dealers

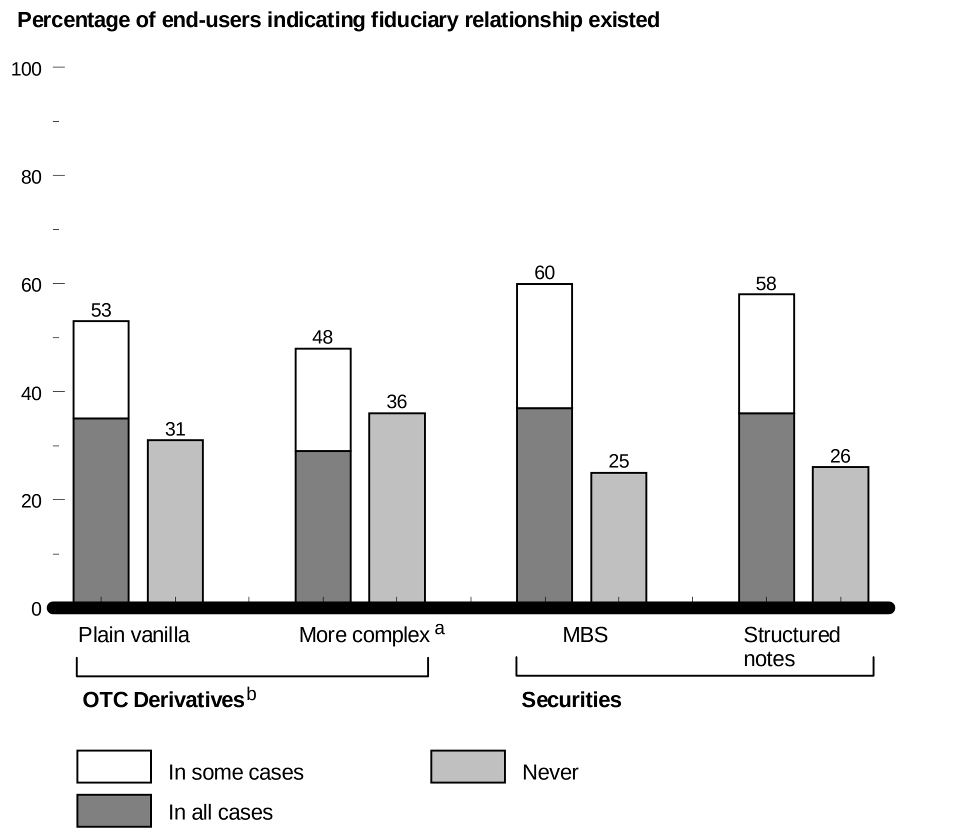
Differences between end-users and dealers in the way they view their responsibilities in transactions involving OTC derivatives, MBS, and structured notes indicate that costly disputes may continue to accompany end-user losses. Our survey indicated that a large percentage of end-users believed that a fiduciary relationship exists when they engage in transactions involving these products. However, additional follow-up contacts with respondents revealed that, when end-users indicated a fiduciary relationship existed, they were expecting dealers to accurately describe product features, performance, and material risks. Our survey also indicated that a significant percentage of end-users relied on dealers for investment advice.

However, end-users' views on counterparty relationships differed from those reflected in voluntary guidance issued by two groups of dealer representatives. In the guidance, transactions in OTC derivatives are presumed to be on an arm's-length basis—with no special responsibilities or reliance expected of either party—unless otherwise agreed to or provided by law. While the dealer-issued guidance is voluntary and intended only to supplement any existing responsibilities that parties to these transactions may have, the approaches to the nature of the relationship, degree of reliance, and expectations for risk disclosure between parties differed in some, but not all, respects from the way that such issues are addressed in existing U.S. and U.K. regulatory requirements applicable to securities, futures, and other financial products.

End-Users Attributed Some Fiduciary Responsibilities to Dealers

In our survey, we asked end-users to indicate the extent to which they believed a fiduciary relationship existed between them and dealers offering OTC derivatives, MBS, and structured notes. However, we did not define the term fiduciary. The responses revealed that a significant number of end-users attributed fiduciary-like responsibilities to dealers in at least some transactions involving these financial products. On the basis of responses to our survey, we estimated that 53 percent of end-users believed dealers had a fiduciary relationship in some or all transactions involving plain vanilla OTC derivatives, and that 48 percent[2] attributed such responsibilities to dealers in some or all transactions involving more complex OTC derivatives, as shown in figure 4.1.

Figure 4.1: Extent to Which End-Users Believed Dealers Had a Fiduciary Relationship



Note: Percentages of end-users indicating no opinion are not shown.

[a]Subject to a plus or minus 16-percent (or less) sampling error.

[b]Includes securities OTC derivatives.

Source: GAO survey.

[2]Subject to a plus or minus 16-percent sampling error. See footnote 2 in chapter 3 for an explanation of sampling errors related to estimates from our survey analysis.

To better understand survey responses indicating that a fiduciary relationship existed, we reviewed comments on returned questionnaires and conducted follow-up telephone interviews with 50 judgmentally selected respondents, including those that were both satisfied and dissatisfied with dealer sales practices. In explaining their response that a fiduciary relationship existed, most end-users told us that this meant dealers had a duty to disclose adequate information about the products and their risks. Many end-users also commented that dealers should be truthful and provide accurate information. In addition, some end-users indicated that dealers should generally have the end-users' best interests in mind. For example, an official at a GSE that used OTC derivatives, MBS, and structured notes told us that, although a legal fiduciary relationship did not exist, his organization expected dealers to be open and forthcoming with information, and that this expectation creates responsibilities for dealers similar to those of a fiduciary.

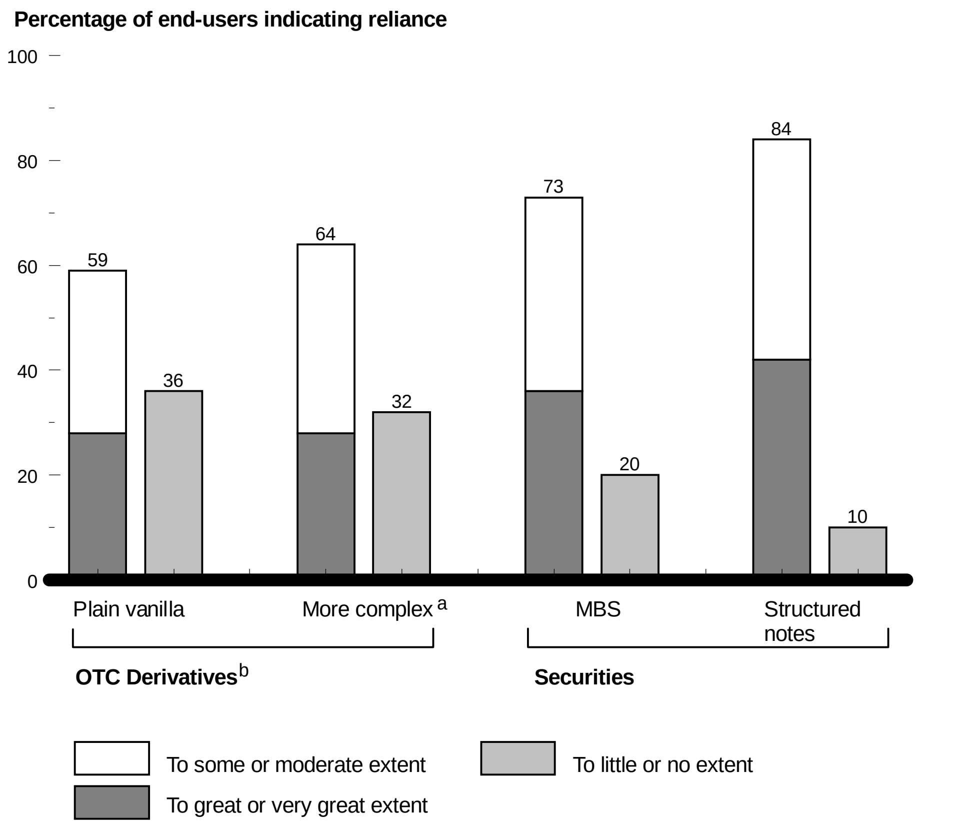
The percentage of end-users that believed fiduciary relationships existed as part of transactions in these products was generally similar across OTC derivatives, MBS, and structured notes. As discussed in chapter 1, no specific federal sales practice requirements apply to OTC derivatives that are not securities or subject to the CEA antifraud provisions. However, MBS and structured notes are subject to the antifraud provisions of federal securities laws, which require dealers to disclose risks and assess the suitability of transactions involving such products for end-users. Because the percentages of end-users indicating that a fiduciary relationship existed for transactions involving OTC derivatives were not significantly different from the percentages for securities products, it does not appear that the different requirements afforded these products greatly influenced the degree of responsibility that end-users placed on dealers.

However, our analysis of survey responses revealed some differences by type of industry. Officials of state and local governments were more likely than those from most other organizations to report believing that a fiduciary relationship existed in some or all transactions involving OTC derivatives, MBS, and structured notes. In contrast, GSEs were significantly less likely than organizations in some other industries to report that such a relationship existed between them and their dealers. Because of the small number of respondents within some industry groups, statistically valid comparisons between most industries could not be made. However, overall, the responses across industries generally indicated that entities whose primary function included operating or managing portfolios of financial assets—such as GSEs, mutual funds, commodity pools, and money managers—were least likely to believe that a fiduciary relationship existed. Entities whose use of these products was generally more limited, such as state and local governments and nonfinancial corporations, were correspondingly more likely to believe a fiduciary relationship existed.

End-Users Also Indicated Reliance on Dealers for Investment Advice

In addition to views regarding fiduciary responsibilities, end-users indicated that they relied to some extent on dealers to provide investment advice as part of these transactions. As shown in figure 4.2, the percentage of end-users that indicated they relied on dealers to provide investment advice from some to a very great extent ranged from 59 percent for plain vanilla OTC derivatives to 84 percent for structured notes.

Figure 4.2: Extent to Which End-Users Relied on Dealers for Investment Advice



Note: The percentages of end-users indicating no opinion are not shown.

[a]Subject to a plus or minus 15-percent sampling error.

[b]Includes securities OTC derivatives.

Source: GAO survey.

Dealer-Issued Guidance Asserts an Arm's-Length Relationship

In 1995, two dealer groups each issued guidance that addresses sales practices, including the nature of the relationship and the specific responsibilities of parties to transactions involving OTC derivatives. The first set of guidance, the Framework for Voluntary Oversight (the Framework), was issued by the Derivatives Policy Group in March 1995. This group consists of six securities firms whose affiliates did approximately 90 percent of all U.S. securities firm-related business in nonsecurities OTC derivatives.[3] The Framework was issued in response to concerns by Congress and others that the nonsecurities OTC derivatives activities of these firms were conducted in affiliates not subject to any direct U.S. regulation.[4] The Framework contains procedures the participating firms have agreed to voluntarily follow in four major areas related to OTC derivatives, including counterparty relationships, which address dealer sales practices.[5] Specifically, the counterparty relationships section consists of guidelines for professional intermediaries to follow in dealing with nonprofessional counterparties. Currently, the Framework applies only to the six firms and only to their nonsecurities OTC derivatives activities.[6]

In August 1995, six financial industry groups,[7] in coordination with the Federal Reserve Bank of New York, released the Principles and Practices for Wholesale Financial Market Transactions (the Principles). The purpose of the Principles is to define the relationship between institutional

[3]The six firms include CS First Boston, Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Salomon Brothers.

[4]See chapter 2 for more detail on the regulatory structure under which these firms operate and chapter 6 for a discussion of SEC and CFTC monitoring of these firms.

[5]The other three areas are management controls, reporting, and evaluation of risk in relationship to capital.

[6]The Framework enumerates the products it covers. SEC officials told us that, in general, it addresses OTC derivatives not otherwise subject to regulation under the securities laws.

[7]The six groups included the Emerging Markets Traders Association, the Foreign Exchange Committee of the Federal Reserve of New York, ISDA, the New York Clearing House Association, the Public Securities Association, and the Securities Industry Association. Since being issued in August 1995, the Principles has been endorsed by two additional associations, the Institute of International Bankers and the Bankers Roundtable.

participants and to set out sound practices to be followed as part of transactions in OTC financial products, including OTC derivatives, MBS, and structured notes. This guidance does not purport to apply to transactions involving retail customers. The Principles resulted from an invitation by a senior official at the New York Federal Reserve Bank to representatives of the six groups to develop a code of conduct for U.S. financial markets.[8] In contrast to the Framework, the Principles was promoted for use by all institutional market participants and does not make distinctions in its recommended practices on the basis of any differences in the professional or nonprofessional nature of the parties to a transaction.

Although differences between the two sets of dealer-issued guidance exist, we did not find these differences to be material. One of the members of the Principles drafting committee, whose firm also served on the committee that developed the Framework, reached the same general conclusion. At an April 5, 1995, public meeting at which the Principles drafting committee discussed the provisions of Principles, he stated that the spirit of the two documents is the same and that it would be unfair to contrast them simply because they use different language in some sections.

Overall, we found that the two sets of dealer-issued guidance advocate a similar approach to counterparty relationships. Both assert that the relationship between counterparties—unless otherwise agreed to by the parties or provided by law—is arm's length with neither party relying on the other, even if information is exchanged. Also, neither set of guidance requires risk disclosure on specific transactions by either party, although each states that the parties should consider exchanging such information when the transaction is more complex or involves leverage. The summary introducing the Framework also indicates that the six participating firms have agreed to provide a generic risk disclosure document to new counterparties.[9] In addition, both sets of guidance recommend similar procedures for exchanging pricing information and controlling and supervising personnel. Furthermore, both state that they are not intended to create legally enforceable obligations; however, courts could find the guidance useful in evaluating counterparty relationships and defining counterparties' respective common law responsibilities. Table 4.1 compares the major sales practice provisions of the two sets of guidance.

[8]Several such codes existed for foreign market participants, but no code existed for U.S. market participants.

[9]The counterparty relationships section of the Framework states that firms "should consider providing" these generic risk disclosure documents.

Table 4.1: Key Sales Practice Elements of the Dealer-Issued Guidance

Element	The Framework	The Principles
Nature of the relationship	Transactions are predominantly arm's length in which each party has the responsibility to review and evaluate the terms, risks, and benefits of the transaction.	Transactions are arm's length and both parties should have the capability to understand and make independent decisions about transactions.
Reliance on the dealer	A dealer should not create the impression that it is acting in an advisory capacity and should take steps to clarify the relationship if the counterparty indicates that it believes the dealer is acting in such a role.	Absent any written agreement or applicable law or regulation, information passed between the parties should not be construed as investment advice or recommendations upon which the other party may rely.
Disclosure of risk	No disclosure is required on specific transactions, but the summary indicates participating firms have agreed to provide a generic risk disclosure statement that describes principal OTC derivatives risks and that clarifies the nature of the counterparties' relationship. Also, when specifically requested, particularly for more complex or leveraged transactions, dealers should provide additional information that accurately presents the potential transaction's risks and benefits, such as scenario analyses (which shows how a product's value may change under different market circumstances).	No disclosure is required, and, if none is requested, the counterparties are to assume that each has sufficient information about transaction risks and terms for its decisionmaking process. A written outline of the material terms of the transaction is considered helpful. If a transaction is particularly complex or has significant leverage, counterparties are advised that they may wish to share more information, such as scenario analyses.
Disclosure of valuation or pricing information	When provided, such information should be prepared in good faith and should not be misleading. Dealers should take steps to ensure that their counterparties understand the type of price quote or valuation they are receiving (i.e., indicative price, firm price, or mid-market valuation).	Counterparties are not obligated to provide valuations but should have policies to address the specific methodology used for calculating such information. If unable to internally value transactions, counterparties should seek external valuations and clearly indicate the desired type of valuation information being sought.
Internal controls	Dealers should adopt internal policies and procedures to foster strong relationships with counterparties. Mechanisms should be in place for supervising activities of personnel engaged in OTC derivatives transactions.	Counterparties should have board or senior management-approved policies covering their use of financial products and should maintain and enforce controls and compliance procedures, including those relating to supervising personnel, to ensure that such transactions are conducted in accordance with applicable legal and regulatory requirements, internal policies, and other requirements.

Sources: GAO analyses of the Framework for Voluntary Oversight and the Principles and Practices for Wholesale Financial Market Transactions.

As a part of stating that neither counterparty should rely on the other, both the Framework and the Principles advocate that each party should be capable of independently analyzing prospective transactions. This expectation is generally consistent with existing risk management guidance, such as that issued by the Group of Thirty[10] and others, for

[10]The Group of Thirty is an international financial policy organization whose members include representatives of central banks, international banks and securities firms, and academia.

entities engaging in transactions in OTC derivatives, MBS, and structured notes. This other risk management guidance typically recommends that such entities have adequate risk management systems in place, including the ability to measure and control the risks associated with using these products. The Framework and the Principles echo this advice by maintaining that each party is responsible for assessing the risks of a transaction and its own risk tolerance or capability for managing such risks. While stating that the relationship between parties is arm's length, both sets of guidance advocate that parties clarify their relationship or obligations in writing. For example, the Principles states that any changes in the assumed relationship from one of arm's length should be agreed to in writing.

Although the two sets of dealer guidance indicate that entities wishing to adhere to them should implement certain practices or controls, neither establishes any minimum responsibility for disclosing the risks of specific transactions—although this is an area where problems and disputes have arisen. Nonetheless, when such information is shared, both sets of guidance offer advice on the types of disclosure that could be made and provide suggestions for making certain kinds of disclosures. For example, both discuss providing scenario analyses that are not misleading and that adequately explain any assumptions made.

Both sets of guidance also indicate that all dealings should be conducted fairly and accurately. For example, the Framework states that dealers should conduct their OTC derivatives activities honestly, in good faith, and in a manner consistent with the promotion of public confidence in the integrity of the markets. It also indicates that all materials should be accurate and reasonable and that professional intermediaries "should consider including legends with those materials that identify various assumptions underlying the analyses presented, describe market factors that may affect the analysis, and/or inform the party receiving the materials that a variety of assumptions and market factors may affect the analysis." Similarly, the Principles indicates that "a Participant should act honestly and in good faith when marketing, entering into, executing and administering Transactions." It subsequently indicates that any communications between the parties, either oral or written, should be accurate and not intentionally misleading. The Framework and the Principles also urge that any assumptions used in scenario analyses be reasonable and that the unique market terminology and conventions of particular transactions not be used in a misleading way.

The Framework and the Principles also note that participants must be mindful of the potential for transactions to result in disputes as well as to expose them to compliance risk—the risk of loss from counterparty or shareholder lawsuits, regulatory fines, and voided contracts—and reputation risk—the risk of loss from reduced revenues and firm value. Both sets of dealer guidance acknowledge that certain transactions pose greater levels of these risks, such as when the transaction is more complex or involves leverage, or when the counterparty lacks sophistication or the capability to independently analyze the transaction. In such cases, both indicate that participants may wish to increase the amount of information they exchange, involve additional internal personnel or external advisors in negotiating the transactions, or take other steps, including avoiding the transaction. Both sets of guidance also advocate that counterparties establish policies and procedures to assess and mitigate the extent to which these transactions create compliance and reputation risks for each party, such as when counterparties appear to believe that the dealer has assumed an advisory role.

The Dealer-Issued Guidance Differs in Some, but Not All, Respects From Regulatory Standards Applicable to Other Activities

To identify any significant differences between the dealer-issued voluntary guidance[11] and other existing sales practice standards, we compared the major tenets of the dealer guidance to the approaches embodied in bank supervisory guidance, a foreign code of conduct, and U.S. commodities and securities laws.[12] Differences between the dealer-issued guidance and these other standards could generally be attributed to differences in their purpose and intent, products covered, or entities subject to them.

The sales practice requirements placed on banks that market OTC derivatives are largely consistent with the dealer-issued guidance, although certain differences exist. Similar to the dealer-issued guidance, OCC and Federal Reserve guidance each indicates that bank counterparties are ultimately responsible for ensuring the appropriateness of transactions with bank dealers. Similar to the dealer-issued guidance, OCC guidance does not specifically require risk disclosure on individual transactions. The Federal Reserve guidance appears to require risk disclosure as it expects banks, if they determine that a counterparty is unsophisticated, to

[11]The drafters of the Principles intended that their guidance be applicable to all institutional financial market transactions, not just to those involving OTC derivatives. Nonetheless, they have acknowledged that entities adhering to the guidance are not relieved of any obligations under existing law.

[12]We were aware when doing these comparisons that the dealer-issued guidance is most relevant to transactions involving nonsecurities OTC derivatives, which currently lack a specific body of law relevant to sales practices.

take steps to ensure that the counterparty is made aware of transaction risks. The goal of bank supervisory guidance as it relates to OTC derivatives is to promote the safety and soundness of regulated institutions; it is not specifically intended to protect those who engage in financial transactions with these institutions.

The expectations for dealers set out in the dealer-issued guidance are also similar in some, but not all, respects to the requirements applicable to futures trading in the United States. Similar to the dealer guidance, U.S. commodities laws do not require entities marketing futures and exchange-traded options to determine whether such products are suitable for their customers. However, in contrast to the Principles, U.S. commodities laws require that the customer be apprised of the significant risks of buying and selling these products, including disclosing that the prices of futures and options can be volatile and that the customer may incur losses that are larger than the amount originally invested.

The dealer-issued guidance is most similar to regulatory requirements issued in one of the major foreign markets for OTC derivatives and foreign exchange. In July 1995, the Bank of England issued an update to The London Code of Conduct,[13] which was developed in conjunction with U.K. market participants. Similar to the U.S. dealer-issued guidance, the U.K. code establishes that the nature of the relationship for products in institutional markets involves transactions between principals, with end-users assumed to be capable of independently evaluating the transaction. In addition, the U.K. code states that if the end-user wishes to retain the other party as an adviser, it should do so in writing.[14] Just as with the U.S. dealer-issued guidance, the U.K. code also states that participants share an interest in maintaining high standards of business conduct and fair dealing. However, whereas compliance with the U.S. dealer-issued guidance is voluntary, compliance with the U.K. code is mandatory. The code indicates that the U.K. central bank—the Bank of England—will view breaches of its provisions seriously, will investigate complaints, and may employ a range of sanctions against violators.

The responsibilities envisioned by the dealer-issued guidance contrast most with the SEC requirements imposed on dealers marketing securities in

[13]The London Code of Conduct: For Principals and Broking Firms in the Wholesale Markets, Bank of England (London: July 1995).

[14]The U.K. code classifies securities firms, banks, and other financial institutions as "core" principals and considers other institutions, companies, and governments as "noncore" principals active in these markets. Core principals are expected to adhere to this code in their dealings and noncore principals are expected to understand these institutions' roles and responsibilities.

the United States. Although the Framework and the Principles do not supersede existing regulatory requirements, they vary in several major respects from U.S. securities law requirements. Whereas the dealer-issued guidance asserts that an arm's-length relationship exists between counterparties, dealers marketing securities are expected to ensure that transactions they recommend are suitable, given the investment objectives, financial condition, and sophistication of the end-user. Disclosure of transaction risk, which the dealer-issued guidance makes optional for specific transactions, is generally expected as part of securities transactions.

The differences between the dealer-issued guidance and U.S. securities laws may stem, in part, from differences in the types of entities to which each applies. The dealer-issued guidance addresses transactions between participants who tend to be large financial and commercial entities and tend to be financially sophisticated. In addition, the dealer-issued guidance does not apply to individual investors. In contrast, the antifraud provisions of the U.S. securities laws apply equally to all investors and do not distinguish between institutional and individual end-users.[15] Furthermore, the required disclosures that must be made as part of corporate securities issuances are designed to ensure that any superior knowledge about the financial condition and risks associated with the entity issuing the securities are made known to prospective investors.

Reconciling the Views of End-Users and Dealers Could Be Difficult

End-user and dealer reactions to the specific tenets of the Framework and the Principles have been mixed. Such reactions may reflect the parties' differing interests when it comes to defining the nature of their relationship in transactions involving OTC derivatives. Part of the difficulty arises because altering the nature of the relationship between end-users and dealers affects the costs of the transaction to each party. In addition to the dealer-issued guidance, actions by a dealer group to standardize contract language as well as judicial decisions related to sales practice issues have not completely resolved the differences in end-user and dealer views. Therefore, various market participants have recognized the need to resolve these differences, and some have acknowledged that the involvement of federal financial market regulators might be necessary.

[15] In some cases, U.S. securities laws make distinctions between types of investors, such as the reduced disclosure requirements pertaining to private placements of securities. NASD's recent suitability interpretation also addresses dealers' responsibilities to institutional versus other end-users.

Reactions to the Tenets of the Dealer-Issued Guidance Have Been Mixed

End-user representatives, including EUDA, GFOA, the National Association of State Treasurers (NAST),[16] the North American Securities Administrators Association (NASAA),[17] and the Department of Labor have criticized the tenets of the dealer guidance.[18] Others, including legal experts, have also voiced concerns about specific provisions of the guidance. In contrast, representatives of dealers and certain other organizations have supported the guidance.

Although public comments were not sought on the Framework, the drafting committee of the Principles solicited comments before finalizing the guidance. We analyzed the comment letters to identify the views of end-users and others on the specific tenets of the dealer-issued guidance, many of which were common to both the Principals and the Framework. Of the 21 organizations that commented, we spoke with 9 that provided substantive criticisms of the Principles. These nine organizations told us that their primary criticisms had not been addressed in the final version of this guidance.

One of the primary objections raised by commenting organizations was that the dealer-issued guidance inappropriately assumes that an arm's-length relationship should prevail for all transactions. Those citing this issue argued that the dealer guidance thus imposes a "one-size-fits-all" model on end-users despite their varying levels of financial sophistication. For example, in their joint comments on the final draft of the Principles, three associations representing governmental entities[19] stated that because the guidance uses the term "participant" to refer to both dealers and end-users, no distinction is made between their respective roles and responsibilities. As a result, they believe that the value of most of the document is negated. Additionally, the associations stated that end-users are a diverse group and that assuming they all have equivalent levels of expertise, responsibility, and access to information is erroneous.

[16]NAST is a 75-member association of state and territorial treasurers, deputies, and staff.

[17]NASAA members are the securities regulators of the 50 states, the District of Columbia, Puerto Rico, the Canadian provinces and territories, and Mexico. It develops model codes and guidelines, facilitates cooperative enforcement efforts, fosters information-sharing, and provides training.

[18]As well as reviewing journal articles and conference proceedings, we also obtained copies of critical letters that various organizations sent to the drafting committee of the Principles. These organizations included the Treasury Management Association, the Financial Executives Institute, NASACT, and the New York State Bar Association.

[19]The three associations were GFOA, NAST, and NASAA.

Another criticism has been that the Principles may reduce end-users' legal protections. In a May 3, 1996, letter to the Federal Reserve Bank of New York, EUDA noted that Bankers Trust offered the Principles as documentation of common practices for OTC derivatives transactions in support of its litigation with Procter & Gamble. EUDA indicated that Bankers Trust's action affirmed the association's original concerns that the Principles would be used by dealers to reduce the legal protections afforded end-users. EUDA characterized the Principles as "essentially a unilateral effort on the part of the dealer community to shift responsibilities from the dealers to end-users and to buttress the position of the dealers in pending and possible future litigation." Some have argued that adherence to the dealer guidance may negatively affect the ability of end-users to claim reliance on dealer representations. GFOA, NASACT, and NAST stated in a joint issuance to their members that they might inadvertently waive existing legal rights if they agreed to be bound by the Principles without careful prior review.[20] In their letter commenting on the draft of the Principles, these organizations also indicated that the attempt by the guidance to preclude reliance on a dealer was not realistic because potential investors should be able to, and often do, rely on representations made by dealers about products. However, the organizations stated that the guidance would require written acknowledgement by the dealer before any such reliance could occur.

Some of the commenting organizations also objected to the guidance because it does not place any responsibilities on dealers to disclose transaction risks or valuations. For example, in its November 1995 newsletter, EUDA stated that the Principles drafting committee had "philosophically rejected the idea that dealers should have any affirmative obligation to disclose material risks of OTC derivative transactions to end-users, irrespective of the complexity or novelty of the transactions." Later in that newsletter, EUDA stated that "the final Principles make it clear that a dealer is not obligated to provide periodic valuations to its end-user counterparty, regardless of whether the instrument sold is a proprietary product of the dealer for which market valuations are neither publicly available nor readily ascertainable." The associations representing governments stated that the guidance should recognize a dealer's affirmative obligation to provide information material to a transaction instead of requiring an end-user to request it. They believe that failing to do so inappropriately assumes that both sides have equal information. They also objected to the Principles' assumption that any additional

[20] State and Local Government Investor Protection ALERT, GFOA, NAST, and NASACT (Washington, D.C.: Oct. 16, 1995).

transaction information, if not specifically requested, is considered unnecessary.

In commenting on the Principles, various associations representing governmental entities stated that the Federal Reserve's agreement with Bankers Trust[21] would be a better model for disclosing risk and ensuring that end-users understand transactions.[22] Such a model would require dealers to (1) provide every counterparty with information about the material terms and risks of any applicable proposed transactions, (2) ensure that every counterparty could understand such terms and risks, and (3) ensure that the means by which product prices and values are determined are reasonably clear to counterparties. Dealers would also be required to meet specific disclosure obligations for proposed transactions.

Another criticism of the guidance was that end-users were insufficiently involved in their development. For example, the Department of Labor stated in its comment letter on the draft Principles that "entities which had no involvement in the creation of the Principles, had not agreed to adhere to the Principles, or may not even have known of its existence could be viewed as subject to the Principles." The agency also stated that the Principles should only apply to entities that subscribe to them in writing. According to EUDA, "the process followed in developing the Principles and Practices was fundamentally flawed" because representatives of the end-user community were excluded from the Principles Drafting Committee. The treasurer of a major utility, who is an EUDA board member, was quoted in an industry publication as stating that "this is probably the only area in the finance world where a group of dealers have shaped both the products and all of the surrounding rules and regulations, with no input from those who are not dealers."[23]

Finally, in a May 1995, letter to the Principles drafting committee, GFOA contrasted the Framework with the Principles by stating that the Framework "takes limited steps in advising professional intermediaries to OTC transactions to disclose information regarding risks, clarify valuation questions, and provide training regarding counterparty relationships." A GFOA official told us that, although these documents call for largely the

[21]The Bankers Trust-Federal Reserve agreement applied these heightened requirements only to those transactions involving significant leverage. The agreement is discussed more fully in chapter 6.

[22]Comments on Principles and Practices for Wholesale Market Transactions, GFOA, NAST, and NASAA (Washington, D.C.: May 19, 1995).

[23]"Resolving the Dealer-User Conflict," Derivatives Strategy, May 1996, Vol. 1, No. 6, page 17.

same practices, GFOA believed that the Framework was more balanced in tone.

Representatives of dealers and other organizations have viewed the Principles more positively. A member of the ISDA board told us that the greater use of OTC derivatives has increased the need for dealers to formally explain their products and activities, including the risks associated with product use and the nature of their responsibilities in these transactions. A managing director at a large U.S. securities firm said that he disapproved of end-users who, when faced with losses, decide that they were not fully informed about the transactions. Therefore, he saw the guidance as valuable for describing the customary way the institutional markets work and for clarifying that dealers, unless otherwise agreed to, do not have fiduciary obligations as part of these transactions. An official from the New York Federal Reserve Bank indicated that the Principles provides a sound basis for relationships between parties conducting activities in financial products. He said that it assumes an arm's-length relationship unless otherwise agreed to and acknowledged that parties can agree to alter this assumption in writing if it does not fit their circumstances. He also stated that the United Kingdom makes the same assumption about the nature of counterparty relationships, and it would be problematic for U.S. practices to be inconsistent with those of other major markets.

The Interests of End-Users and Dealers Conflict When It Comes to Defining Their Relationship

Difficult issues remain to be resolved before the differing interests of end-users and dealers over the nature of their relationship can be reconciled. To date, attempts to address these differences have not been successful. The primary areas of disagreement and uncertainty between end-users and dealers, and among the most difficult to resolve, are the nature of their relationships in transactions involving OTC derivatives that are not securities or futures and whether or not each party can rely on the statements made by the other. Under the securities laws, an implied standard of fair dealing allows end-users to rely on dealer statements and advice about a security. Although both sets of dealer-issued guidance indicate that neither party is presumed to be relying on the other, these documents contain language stating that transactions and communications between parties are expected to be accurate and made in good faith. According to the New York Federal Reserve Bank official who sponsored the development of the Principles, this language means that misstatements are not permissible. An official of a U.S. securities firm that participated in drafting the Principles said that, although neither party has the duty to advise the other about the risks of the transaction, a "buyer beware" philosophy is not assumed because the Principles calls for honest dealings between the parties.

Some dealer officials explained that allowing counterparties to view their firms' statements as investment advice as a part of these transactions can be problematic. They said that to provide investment advice, dealers need to understand the complete financial position of their counterparties; however, end-users are not always willing to provide this information. A managing director at one of the major dealer banks, who also sits on ISDA's board, told us that OTC derivatives contracts require performance by both parties. As a result, it is not reasonable to hold dealers totally responsible for the actions of the end-user.

Dealers also explained that the information they provide is not advice, rather it describes and explains the products. Dealers told us that they offer useful products that can meet the needs of end-users seeking to hedge risks or to obtain an investment return. In explaining how they marketed these products, dealers said they take time to learn end-users needs, assess end-users' current financial condition, and provide end-users education or explanations about products. For example, officials at one U.S. securities firm provided us with a sample of a presentation given to an end-user. The 26-page document included a detailed analysis of the end-user's exposure to changes in interest and currency exchange rates.

However, officials representing end-users and other organizations indicated that when the complexity or other features of some products render their risk characteristics less obvious, then reliance on dealer statements is sometimes necessary. An official working in the treasury of a large end-user commented at an April 1996 conference that, although his firm was financially sophisticated, the effort required to fully analyze the performance of certain complex products was beyond his firm's capabilities. Therefore, the firm needed to be able to rely on dealer statements about how the products would perform as market rates changed. He said that, although the dealers' marketing staff who explain complex transactions are willing to allow his firm to rely on their representations, the dealers' legal staff advised his firm that no such reliance can be made because such firms are seeking to avoid the resulting legal liability. An attorney representing EUDA at a July 1996 forum on these issues said that dealers have superior knowledge about the proprietary products they develop and end-users find replicating the valuations of some products very difficult. During an address to an industry conference, an SEC commissioner said that dealers sometimes are tempted to describe products in sophisticated terms to increase their proprietary value.

Although comments on a draft of the Principles were solicited in a public session, few meetings between end-user and dealer groups have been held. A representative of GFOA said that members of the Principles drafting committee met with their organization and other governmental end-user associations just before issuing the final draft of that document. A representative from another end-user organization told us that his organization had been approached in early 1996 about working on a committee to revise the Principles, but they had declined to participate at that time because, according to this official, participation was made contingent on endorsing the Principles. As of August 1997, no additional meetings for the purpose of reconciling dealer and end-user views on the nature of their relationship as part of OTC derivatives transactions had been held.

The Financial Impact of Altering the Nature of Relationships May Make Resolving Disagreements More Difficult

Resolving disagreements about the nature of the relationship between end-users and dealers may be more difficult because the resolution can affect who bears what costs in transactions involving OTC derivatives, MBS, and structured notes. As our survey and other information indicated, end-users believe they should be able to rely on the information that dealers provide. However, dealers and others told us that, if end-users want to rely on the information provided, then it would be considered investment advice and the dealers would have to increase transaction prices or arrange separate compensation to reflect the increased legal risk in providing such advice. A former securities regulatory official said that reconciling the opposing views of the parties will be difficult because neither wants to assume the likely increased costs of the transactions. He noted that dealers, despite providing sometimes voluminous information about a product and its function, do not wish this information to be considered a recommendation or investment advice that can be relied upon because they do not want to assume any related legal liability. Conversely, he said that end-users want to obtain information from a dealer at no cost, secure competitive price quotes from a number of dealers, and then retain the right to sue the dealer used if the transaction loses money.

In January 1995 testimony before Congress, the Chairman of the Board of Governors of the Federal Reserve System also discussed how altering dealer responsibilities could create additional costs that are detrimental to the markets.[24] The Chairman testified that dealers in financial transactions sometimes assume a role beyond that of a mere counterparty, such as when they provide advisory services. However, if dealers are required to ensure that an end-user's use of a product is appropriate, such requirements may serve as a means for end-users to shift a transaction's risk back to the dealer through legal actions. If such legal risks are exacerbated, dealers may begin charging a premium to cover uncertain future legal claims, and some dealers could move their activities overseas or withdraw from the market altogether. He said that such an outcome would present considerable costs to the economy because of the resulting interference in liquid and efficient markets.

A Dealer Group Proposed Contract Language to Address the Nature of Counterparty Relationships

ISDA proposed standardized language that describes the nature of the relationship between counterparties to OTC derivatives transactions and that could be incorporated into OTC derivative contracts. ISDA suggests that this language be added to the ISDA master agreement—the standardized contract used to document the obligations of parties to OTC derivatives transactions.[25] If included as part of such contracts, each party would be representing that

- it was not relying on the other party and was making its own decisions about the transaction,
- it was capable on its own (or with independent professional advice) of understanding the terms of the transaction and its risks, and
- it was not acting as a fiduciary or an advisor in the transaction.

An official from a large U.S. corporation indicated that his firm refused to sign contracts with this provision. He said that, although his firm did not expect dealers to act as fiduciaries, it wanted to be able to rely on statements of fact made by the dealers about product performance under different market conditions. He noted that, although his firm was large enough to refuse to sign contracts that included language such as that suggested by ISDA, smaller end-users might not have the same clout and thus might sign as a condition of completing a transaction.

An attorney speaking on behalf of EUDA at a July 1996 industry forum said that the organization was cautioning end-users about signing contracts

[24] Testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System: Committee on Banking, Housing, and Urban Affairs; United States Senate (Washington, D.C.: Jan. 5, 1995).

[25] Representation Regarding Relationship Between Parties, ISDA (New York, N.Y.: Mar. 6, 1996).

with this language in the event that doing so waived rights they might otherwise have, such as the ability to claim fraud on the basis of misrepresentations or omissions of fact. Although ISDA had amended the representation in an attempt to address this concern, the attorney told us that she was aware of the amendment when she spoke at the conference and that EUDA's reservations about the representation's language persist.

Recent Court Decisions Have Found That OTC Derivatives Dealers Have Some Responsibilities, but They Have Not Resolved Key Issues

In two cases resolved since 1995, courts have indicated that, although OTC derivatives dealers were not acting as fiduciaries, they were held responsible for being accurate when disclosing transaction risks. The first case, decided in the English Commercial Court in December 1995, was decided in the dealer's favor. Although a U.K. case, the decision is relevant to U.S. OTC derivatives counterparties because many of their swaps personnel are located in London, and the ISDA master agreement used to document OTC derivatives contracts offers the choice of either New York or U.K. law as the governing jurisdiction for disputes. The case concerned two swaps transactions executed between Bankers Trust and an Indonesian business conglomerate. The Indonesian firm claimed, among other things, that the bank had made fraudulent misrepresentations and had a "duty of care" to fully explain the transactions and their risks. The judge found that Bankers Trust had not made a complete disclosure of the risks as part of these transactions. However, he stated that "the parties' respective skill and knowledge in the field is a very relevant, though not by itself, decisive factor." He also noted that officials at the Indonesian firm had held themselves out as being financially sophisticated and had demonstrated their ability to determine the transaction risks, even though the bank had not fully disclosed them. Therefore, the judge determined that Bankers Trust did not have a duty greater than the duty to present fairly and accurately any facts and matters in the representations it made.

Another suit—filed in U.S. District Court by Procter & Gamble against Bankers Trust—may have aided in clarifying the responsibilities of dealers in OTC derivatives transactions, but its early settlement has left opinions divided on its implications. Procter & Gamble filed this suit in October 1994, but the two parties settled in May 1996 before the case was presented to a jury. Under the settlement, Bankers Trust agreed to forgive as much as $150 million that Procter & Gamble owed. On the day of the settlement, the presiding judge responded to an earlier motion for summary judgment by dismissing or ruling in Bankers Trust's favor on all the counts against it except one count alleging fraud and two counts requesting that the contracts be voided. The judge would have allowed these three counts to proceed to trial. Bankers Trust had argued that the transactions in question had been conducted at an arm's length. In the ruling, the judge concluded that Bankers Trust had not been acting for or on behalf of Procter & Gamble as in a typical customer-broker context, but instead the two were principals to a contract and, therefore, no fiduciary duties were imposed. However, he did find that, under New York law, Bankers Trust had a duty to disclose material information about the transaction, both before and during the transactions, and also had a duty to deal fairly and in good faith during the performance of the transactions.

The judge's ruling in the Procter & Gamble case did not definitively settle the extent to which dealers, in general, have responsibilities to disclose material information about transaction risks or the other requirements that may apply to dealers' marketing activities. Since the ruling was made, several journal articles have provided conflicting views on the implications of the judge's ruling on dealers' obligations. At a July 1996 conference in Washington, D.C., representatives of dealers and end-users as well as legal experts also offered conflicting views on the conclusions that could be drawn from the ruling. Furthermore, in its announced settlement with an individual Bankers Trust employee who had marketed these products to Gibson Greetings, SEC stated that it disagreed with the Ohio judge's ruling in the Procter & Gamble case regarding the inapplicability of federal securities laws to certain OTC derivative products.

The Need to Address Conflicting Views on the Nature of Counterparty Relationships Has Been Recognized

Representatives of regulators, end-users, and dealers have recognized the need to reach agreement on the specific responsibilities of dealers as a part of transactions in OTC derivatives, MBS, and structured notes. While speaking at a forum for end-users about the relationship that should prevail between end-users and dealers in institutional market transactions, a New York Federal Reserve Bank official said that activities in these products are important to the economy. Therefore, he said that too much uncertainty is created by leaving these matters to be decided by the courts on the basis of individual case facts and circumstances. Another speaker, an SEC commissioner, called on dealers and end-users to come to common agreement on each party's responsibilities and duties. He cited the inefficiency of having dealers face potentially large legal liabilities over disputes decided by individual courts on the basis of what is usually a brief interaction between the end-user and dealer. He said that such uncertainty would not be tolerated in other areas of business and should not be tolerated in the markets for these products. Thus, he concluded that clarifying the relationship between end-users and dealers could enhance market efficiency and reduce dealers' legal liability. Furthermore, he said that having dealers agree on the rules regarding their responsibilities was better than having thousands of end-users attempting to individually negotiate the nature of their relationship with dealers. However, he also acknowledged that when the nuances of relationships do not fit within the generally agreed-upon framework, then changes could still be individually negotiated.

Others have also recognized a need for end-users and dealers to agree on the nature of their relationship. A former securities regulator said that end-users and dealers need to agree on a set of common terms so that each side understands what type of information the other is providing and which statements can be relied on and which cannot. End-users and dealers should also discuss when and how scenario analyses should be provided. Coming to such agreement could reduce the number of instances where legal disputes occur. In response to an end-user's concerns over the need to rely on the information dealers provide about product features and performance, ISDA's legal counsel agreed that the parties need to discuss these issues with the goal of reaching a consensus. In a May 1996 article, an EUDA board member remarked that the organization hoped to continue to work with dealers to develop mutually acceptable practices for these products.

Some market participants have observed that the involvement of one or more federal financial market regulators may be needed to assist end-users and dealers in resolving disagreements about dealer responsibilities. Speaking at a June 1996 risk management forum, representatives of a large dealer bank and a securities firm indicated that financial regulators had a role to play in assisting the end-user and dealer communities in reaching agreement on their responsibilities. At an industry forum in July 1996, an attorney with futures regulatory expertise commented that the existence of different regulatory requirements and dealer-issued guidance creates confusion over what standards apply or should apply to transactions in these products. He expressed the desire that end-users and dealers jointly come to agreement and suggested that the standards proposed by bank regulators would be a good starting point for considering what form such agreements could take. He and other forum participants indicated that financial market regulators, especially SEC and CFTC, could assist in clarifying the legal standards that are applicable to these transactions. EUDA has also acknowledged that federal financial market regulators could play a role in this process. In a May 3, 1996, letter to the New York Federal Reserve Bank, the end-user association called for guidelines that

> ". . . could be endorsed and implemented by both dealers and end-users. This would require, however, that all sides and views be invited to the drafting table without preconditions. If the Federal Reserve Bank of New York does not want to facilitate such a dialogue under its auspices, we feel certain that other interested persons or government agencies would do so."

Although not calling for federal involvement, the Chairman of the Federal Reserve Board provided some criteria for appropriate regulatory intervention in the markets. In the previously cited January 1995 congressional testimony, the Chairman stated that markets function most efficiently when both parties are free to enter transactions at their own discretion and are unhampered by the need to serve the interests of their counterparties. He emphasized that any consideration of regulation in this area should adhere to the principle that parties to financial transactions are responsible for their own decisions. However, he noted that misrepresentation and fraud could not be tolerated. He also said that, in some cases, end-users may not reasonably be expected to understand the risks involved in certain complex products, and that dealers in financial transactions sometimes act as more than just a counterparty by providing advisory services. According to the Chairman, addressing the situation may require limiting the use of some products to only certain organizations, providing guidance to end-users for investment and risk management, encouraging them to obtain independent advice, or encouraging them to diversify their portfolios. However, he cautioned against approaches that would allow end-users to shift a transaction's risk back to the dealer through legal actions, because such approaches would likely increase transaction costs, discourage dealers from offering these products, and interfere with currently liquid and efficient markets.

Dealers and End-Users Acted to Reduce the Potential for Sales Practice Disputes, but Weaknesses Remain

Regardless of whether end-users and dealers collectively reach agreement on the nature of their relationship, they can individually protect themselves against sales practice disputes by having in place strong corporate governance systems,[1] including internal controls and related practices. In discussions with us, dealers described implementing internal controls and sales practices that were consistent with those advocated by the two sets of dealer-issued voluntary guidance analyzed in chapter 4. Nonetheless, regulators identified weaknesses in sales practices that exposed dealers to the risk of loss. Similarly, end-users described a range of procedures for controlling investment risk; however, some lacked basic controls. Also, reviewing organizations identified specific weaknesses in end-user controls that contributed to losses. To help end-users better manage their activities, professional associations have issued guidance for their members to use in strengthening their corporate governance systems, including their internal controls and related practices. Actions have also been taken by various state governments to reduce the risk of loss associated with the use of OTC derivatives, MBS, and structured notes.

Corporate Governance Systems Can Address Sales Practice Issues

In our previous reports on derivatives, we stressed the importance of organizations having strong corporate governance systems to ensure that risk management and internal control systems are in place and functioning as anticipated. Under an effective corporate governance system, the board of directors approves policies and oversees the organization's activities in financial products, including OTC derivatives, MBS, and structured notes. In addition to losses arising from adverse market movements or counterparty defaults, the marketing and use of these products can expose dealers and end-users to risks that can be similarly costly. Various entities, such as the Federal Reserve, OCC,[2] and the Group of Thirty,[3] have issued guidance that emphasizes the need for sound corporate governance systems to address the risks posed by dealing in and using these products. These sets of guidance are applicable to dealer marketing and end-user investment activities. As discussed at the end of this chapter, various end-user groups

[1]Governance systems are concerned with transactions and relationships within an organization, including who controls which activities, who makes decisions, and who has what responsibilities for which claims against the revenues and assets of a company. Although we refer to these systems as corporate governance, they also apply generally to governmental entities.

[2]In addition to guidance for banks acting as dealers, the Federal Reserve and OCC have issued guidance for banks that use OTC derivatives and other financial products primarily as end-users. See Evaluating the Risk Management and Internal Controls of Securities and Derivative Contracts Used in Nontrading Activities, Federal Reserve Board (SR 95-17) (Washington, D.C.: Mar. 28, 1995) and Comptrollers Handbook: Risk Management for Derivatives, OCC (Washington, D.C.: Oct. 1994).

[3]Derivatives: Practices and Principles, Global Derivatives Study Group, Group of Thirty (Washington D.C.: July 1993).

have also issued guidance that is specifically targeted to their members' investment activities and that addresses the importance of a strong corporate governance system.

Dealers Described Sales Practice Policies and Procedures That Were Consistent With the Dealer-Issued Guidance

The dealers we contacted described sales practice policies and procedures for marketing OTC derivatives, MBS, and structured notes that we found to be consistent with the Framework and the Principles that were discussed in chapter 4.[4] Dealers indicated that the extent to which they disclosed transaction risks depended on the product and the needs of the end-user. In general, they explained that the amount and type of information they disclosed about the risks of transactions in OTC derivatives, MBS, and structured notes varied depending on the complexity of the product. For more complex products, dealers generally indicated that they would provide more detailed descriptions, explanations, and materials about the product's performance and risks. The firms also indicated that scenario analyses were sometimes provided, particularly for more complex transactions. The dealers explained that the amount of information they provided also varied depending on the sophistication of the end-user. For example, officials at one of the large securities firms told us that end-user sophistication was key to determining how much information was included in proposals—that is, the less sophisticated the end-user, the more information they would include.

Although dealers of OTC derivatives, MBS, and structured notes told us that they considered the circumstances of end-users when marketing these products, they did not view this as necessary for all transactions. At least four of the dealers we contacted explicitly stated that they were not responsible for assessing the suitability of OTC derivatives transactions for end-users. However, all of the dealers said that their firms' policy is to tailor transactions to end-user objectives and sophistication. For example, officials at a major bank and a major securities firm indicated that, although suitability determinations are not legally required for OTC derivatives, their staff are generally protective of their relationships with end-users and would not knowingly enter into transactions that were inappropriate for end-users. However, officials at another major securities firm told us that they would enter into a transaction they believed was inappropriate for an end-user if the end-user insisted on proceeding even after hearing the dealer's advice against such action. Dealers also generally

[4]We interviewed or obtained written responses from 14 dealers, including 5 large U.S. securities firms, 3 large U.S. banks, and 1 foreign bank—all of which marketed OTC derivatives, MBS, or structured notes. In addition, we obtained information from two smaller banks and three smaller securities firms that almost exclusively marketed MBS and structured notes.

did not view themselves as acting as fiduciaries in these transactions—most dealers emphasized that the end-users with whom they transacted were generally sophisticated. Officials at one of the large securities firms explained that, as a way of reducing their firm's exposure to compliance and reputation risks, sales staff are required to be alert to indications that an end-user might be viewing the relationship as one involving fiduciary responsibilities for the firm. Such indications could result from observing that the end-user generally entered into all or most of the transactions the firm proposed, or appeared to be doing so, without independent analysis. In such cases, firm policy was for sales staff to ensure that transactions conformed to the end-user's objectives and to discuss the situation with other levels of management within the firm.

Dealers of OTC derivatives, MBS, and structured notes described having similar controls and supervision processes to oversee their marketing of these products and to reduce the likelihood of sales practice disputes. They told us that their primary means of overseeing the firm's marketing activities was by establishing multiple points of review for the transactions. The dealers described requiring staff other than the marketing personnel—such as trading supervisors—to review transactions daily as well as at weekly or monthly intervals. At least four firms had relationship managers who acted as central points of contact for the dealers' activities with individual end-users. In this capacity, such staff were to review the appropriateness of all activity between the dealer and end-users, regardless of which business line within the firm originated the transaction. Furthermore, most of the dealers indicated that their internal audit staff performed reviews of their marketing activities in these products. However, one firm indicated that its internal audit staff had never reviewed these activities.

Most of the dealers of OTC derivatives, MBS, and structured notes told us that they had also made at least some changes to their sales practices or oversight activities within the last few years, primarily in response to publicized sales practice disputes. Five of the dealers indicated that they had revised policies applicable to their marketing of these products. For example, two firms said that they were creating more formal written policies to better document the specific practices they expected their staff to follow. Two other dealers said that they had made improvements to the information they provided to end-users including, in one case, expanding the range of possible market moves used in scenario analyses. Two of the dealers also indicated that they had formed new groups within their firms to review transactions and marketing of these products. One of the firms explained that a new committee within the firm would focus on assessing the compliance and reputation risks of the firm's activities, including how products would be marketed and what type of end-user would be approached.

Dealer compensation practices was another area relevant to the quality of sales practices. The findings of regulators and others indicate that the structure of such compensation can be influential in determining how marketing personnel conduct their activities. For example, to the extent that staff receive higher compensation for more risky transactions that bring the firm greater profits, they have greater incentives to market these types of transactions, even if they are not in the end-user's best interests. One dealer told us that more complex derivatives tend to offer the potential for greater bonuses than plain vanilla OTC derivatives because of their higher profit margin.

In general, dealers told us that their marketing staffs were not compensated solely by commissions on individual transactions. However, we could not determine the extent to which such commissions determined compensation. One dealer told us that its compensation is not a commission system tied to sales volume but a salary and bonus system that is based on the value of business brought into the firm. The dealer explained that, in calculating individual bonuses, overall firm profitability and the relative performance of other departments within the firm might be weighed more heavily than individual performance. The dealer said that the system was designed to reduce incentives for individuals to market high margin, risky products that are not in the end-user's best interests. Some firms told us that deferring portions of the compensation of their personnel was one way they were attempting to align their marketing staffs' interests with those of end-users. Other firms told us that maintaining quality end-user relationships was important to determining compensation.

Regulatory Examinations Surfaced Dealer Weaknesses

Although dealers described following sales practices that were consistent with the dealer-issued voluntary guidance, regulatory examinations indicated that most dealers had some areas where improvements were warranted. As noted in chapter 3, we did not find that a large number of dealers had deficient sales practices. In addition, in examinations conducted from mid-1994 to mid-1995, the Federal Reserve and OCC generally found that large bank derivatives dealers had made efforts to implement appropriate policies, procedures, and internal controls related to sales practices. OCC concluded that the banks it examined were in substantial compliance with its guidance and, in many cases, had developed policies and procedures that went beyond its minimum requirements.

However, both regulators identified weaknesses in sales practice-related areas at these banks that could expose them to compliance and reputation risks. Among the weaknesses identified in internal controls were inadequacies in the risk disclosure materials provided to potential counterparties. For example, some banks' risk disclosure materials did not show how a product would perform across a sufficiently wide range of market conditions.

Regulators also identified weaknesses in the supervision of marketing personnel, including failure to provide for supervisory approvals of the prices quoted by marketing personnel to end-users. Some banks also lacked comprehensive, written policies and failed to adequately document transactions. Finally, OCC found that, in some cases, bank communications to end-users could be construed as advisory, which could expose banks to litigation if the transactions resulted in losses.

Banks may continue to have such weaknesses in their sales practice policies and controls. According to a bank regulatory official who oversees some of the major dealer banks, the examinations they have conducted since 1995 have continued to find weaknesses like those identified above. This official noted that banks have made improvements to their policies and controls relating to sales practices since 1994 and 1995, but that additional improvements are needed.

End-Users Described a Range of Controls, but Some Lacked Basic Controls

Our review found that the policies and controls varied widely at the organizations we contacted that used OTC derivatives, MBS, and structured notes. From a judgmentally selected sample of respondents to our survey, we obtained information through telephone interviews about the practices and controls in place at 50 organizations that had used OTC derivatives, MBS, or structured notes or that had only heard dealer presentations on these products. The organizations we contacted described a range of policies and practices governing the use of these products.[5] Some described very sophisticated and involved processes, whereas others acknowledged that very few formal policies or practices existed. For

[5]We did not obtain complete information from every organization we contacted, therefore, totals for individual policies or controls do not add to the total number of organizations contacted.

example, one end-user reported having an extensive set of policies that it updated every quarter. Twenty-eight respondents said that they had their own investment guidelines. Officials of four organizations said they followed guidelines provided by their regulator or local governmental authority. Officials at three organizations said they did not have formal investment policies because of their small size or lack of investment activity.

Restrictions on using particular products also varied across the organizations we interviewed. Although we did not obtain complete information for all organizations, at least 30 respondents said that they limited purchases to specific products or had formal prohibitions against investing in certain products. However, five entities had no restrictions on which products they could use. In addition, 22 of the organizations described limiting their use of these products to certain situations or for specific purposes. For example, some of these organizations said they limited their use of OTC derivatives to adjusting exposure to changes in interest rates.

The ability to independently price or stress test the values of products held and the existence of a robust process for reviewing and approving transactions are important controls over investment activities. Of the 26 organizations that provided information on their ability to price or stress-test their holdings, 12 indicated they could independently do so. Six others indicated that they relied on assistance from dealers or other parties to conduct such activity. Four indicated that they did not attempt to stress test their portfolios.

The processes respondents used to approve or review transactions also varied. Although 31 respondents said that they required some sort of approval before purchasing a product, the levels of review and authorizing parties varied greatly. In some cases, portfolio managers or treasurers approved transactions; whereas in other cases, approval was required by an investment committee or by the company president. Twenty-two respondents reported controlling their use of these products by entering into transactions only with dealers that had been previously approved. To become an approved dealer, these organizations evaluated dealers' credit ratings and other factors, such as their reputation. Two respondents reported that they only approved dealers that sign an agreement acknowledging that they understood and would follow the end-users' investment guidelines. Five other end-users, which said they did not conduct such evaluations, indicated that they would only use dealers with high credit ratings.

Consistent with the descriptions of the practices followed by respondents we contacted, surveys by other organizations also found that end-user practices and controls varied across firms.[6] For example, a 1995 survey by the Wharton School of Business found that while 76 percent of respondents had policies addressing their use of these products, only 3 percent reported results monthly to their boards, 25 percent reported results quarterly, 20 percent reported results annually, and 51 percent reported results on an as-needed basis.[7] This survey and one other[8] also found that just under one-half of the respondents conducted stress-testing or scenario analyses on their portfolios to determine how they could be affected by severe market changes. A 1995 survey of 75 large, multinational corporations found that their ability to internally determine the value of their holdings varied widely across these organizations, depending on the products involved. Seventy-six percent reported being capable of pricing forwards and futures contracts, but only 38 percent of the corporations reported that they could independently price swaps and swaptions,[9] and 14 percent reported such capabilities for complex options.[10]

Other surveys also found that the controls employed by end-users varied. Separate surveys by two financial journals of between 150 and 200 large U.S. firms reported that the authority for entering into transactions in OTC derivatives and similar products resided mainly with senior managers who were responsible for the organizations' finances, but that some firms had

[6]We attempted to confirm that the organizations and products examined in these other surveys were generally comparable to those discussed in this report; however, we did not otherwise assess the quality or verify the results of these surveys.

[7]1995 Survey of Derivatives Usage by U.S. Non-Financial Firms, Wharton School of Business/Canadian Imperial Bank of Commerce/Wood Gundy. (Philadelphia, PA: Oct. 1995). This survey received 142 responses from end-users in a random sample of U.S. publicly held nonfinancial firms.

[8]"Survey of CFOs," Institutional Investor Magazine (June 1995). This survey received 150 responses from chief financial officers from a judgmentally selected sample of large U.S. public and private corporations.

[9]A swaption is an option that grants the holder the right to enter into a swap with predetermined terms.

[10]Emcor Fax Survey, Emcor Risk Management Consulting, Inc. (Nov. 1995). This survey received 75 responses from finance officers from a judgmentally selected sample of large, multinational corporations.

recently begun requiring additional levels of approval.[11] Similarly, an accounting firm's survey of U.S. and international investment fund companies reported that one-third of those surveyed who had used derivatives had a supervisory board or risk management committee that established limits on the use of derivatives and similar products.[12]

A more recent survey that addressed the practices of end-users also showed that practices varied across organizations. In November 1996, one of the large public accounting firms issued a survey of almost 700 financial and nonfinancial organizations that used exchange-traded and OTC derivatives.[13] According to this survey, although these organizations followed generally consistent practices in accounting for these transactions, a range of practices existed for how they defined and evaluated the risks of these activities.

Reviewing Organizations Found That Weaknesses at End-Users Contributed to Losses

Although concerns over dealer sales practices have arisen in a number of recent losses, in some of these cases, weaknesses in the end-user's internal controls and practices contributed to the end-user's losses. Various groups have called for end-users to improve their management of and controls over the use of products like OTC derivatives, MBS, and structured notes to reduce the potential for losses and resulting sales practice disputes. The types of controls advocated by these groups are intended to reduce end-user dependence on the information provided by dealers and the resulting vulnerability to deficient dealer sales practices. Federal and state regulators, state audit departments, and other reviewing organizations that examined end-user losses where sales practice disputes existed found that the end-users involved had multiple weaknesses in their internal controls and practices that contributed to their losses. We reviewed the reports and findings of these organizations for nine cases where an end-user incurred a loss and subsequently alleged deficient dealer sales practices. Among the weaknesses identified at these end-users were inadequacies related to investment policies, oversight of investment activities, separation of duties, staff training and qualifications, and internal audits.

[11]"Reader Survey" and "1995 Derivatives Survey," Treasury and Risk Management Magazine (Spr. 1993 and July-Aug. 1995). This survey received 95 responses in 1993 and 201 responses in 1995 from finance officers from a judgmentally selected sample of U.S. public and private nonfinancial corporations. "Survey of CFOs," Institutional Investor Magazine (June 1995).

[12]Derivatives Usage by Investment Funds, Ernst & Young, LLP (Oct. 1995). Ernst & Young surveyed a judgmentally selected sample of 143 U.S. and foreign investment fund companies in 1995.

[13]Survey on Current Accounting for Risk Management Activities, KPMG Peat Marwick (Nov. 1996). This survey received 139 responses from officials at a judgmentally selected sample of 700 financial and nonfinancial organizations that used forwards, futures, swaps, and options.

Regarding investment policies, regulators and others have frequently recommended that, at a minimum, entities using OTC derivatives or investing in financial instruments, such as MBS and structured notes, identify their objectives for using such products, the type of products approved for use, and the extent to which the products will be used. However, in five of the nine cases we reviewed, the reviewing organization found that end-users had material weaknesses in their policies addressing product use and, in some cases, lacked formal written policies. For example, a State of California report on Orange County's losses noted that the county did not have a written investment plan against which its activities could have been compared before the losses occurred. Also, its investment policies did not establish limits on the level of risk allowed for the county's investments. In 1994, a Texas community college incurred a $3-million loss when it sold part of its portfolio of highly volatile CMO tranches. The college had also experienced an $11-million decline in the market value of its remaining portfolio, which originally had a book value of over $31 million. The state auditor found that the college had no policies related to controlling the risk of its investments, their desired level of liquidity, or the extent to which they should be diversified.

Regarding oversight of investments, a key control identified by most reports and other guidance on the use of OTC derivatives and products with similar characteristics is the need to supervise the activities of staff engaging in such transactions to ensure that guidelines are followed and activities are prudent. Seven of the nine audit reports of end-users incurring losses identified lack of controls for monitoring investment activity and personnel as contributing to these losses. For example, the treasurer at one Texas county was allowed to enter into transactions without prior approval. He invested over 65 percent of the county's investment funds in long-term, high-risk CMOs. The value of the $12.7-million portfolio later declined by as much as $4.5 million.

A related control is to adequately separate officials' duties and responsibilities. Internal control standards generally require that internal auditors report to officials other than those that directly oversee the activities they are auditing. This control was absent in one county that experienced losses because the comptroller was responsible for making the county's investments and for approving any internal audit of his activities—approval which he had never granted. An official of another county was responsible for both executing investment transactions and preparing the accounting records that reported their value. Because these two duties were not assigned to separate staff, the official was able to falsify the accounting records to hide the full extent of the losses that resulted from transactions he executed.

Federal and state regulators and state auditors also criticized some end-users for lacking staff that were adequately trained or that possessed sufficient understanding of the risks involved in using complex financial products. Six of the nine audits we reviewed indicated that investment personnel or supervisory staff did not sufficiently understand the risks involved with the products purchased or lacked the expertise to properly monitor complex investments. This lack of understanding is not surprising because the treasurers of some local entities are elected officials who may have no experience investing in sophisticated financial instruments. In these situations, external oversight assumes even greater importance because, as some of the reviewing authorities noted, the lack of expertise on the part of end-user personnel led them to rely heavily on dealers for advice.

Finally, some end-users lacked adequate internal audits. Thorough internal audits can lead to corrective action when investment policies and procedures are deficient or not being followed. At three end-users, the reviewing organizations noted that audits of investment activities either were not being done frequently enough or were not sufficiently addressing whether investment activities were in compliance with policies or other guidance. State auditors noted that the investment activities at one community college had not been reviewed by county audit staff in at least 5 years.

Various Organizations Issued Guidance for End-Users

In response to recent reported losses, various organizations issued guidance on recommended practices for reducing the risks of engaging in OTC derivatives, MBS, and structured note transactions. Although most of the recommended practices we reviewed addressed issues faced primarily by dealers, we identified four sets of guidance issued by professional associations or groups that address issues faced by end-users. In June 1994, GFOA issued guidance to its members on the policies and practices that governmental entities should have in place before using derivatives.[14] About 1 year later, NAST issued revised guidance[15] that focuses on preferred practices for government-administered investment pools in which smaller state and local government funds are pooled and invested centrally. That same year, the Treasury Management Association (TMA)[16] issued guidelines on internal controls and appropriate disclosures for end-users of derivatives.[17] Finally, in November 1996, the Risk Standards Working Group (RSWG)[18] issued 20 standards for managing and measuring risks.[19] The GFOA and TMA guidance is written specifically for derivatives use, while NAST and RSWG guidance is intended for all investment products. All four sets of guidance favor explicitly written policies and objectives that have been approved by executive management or the board of directors.

As shown in table 5.1, the four sets of guidance also call for similar practices, which, if not followed, can leave an end-user more vulnerable to sales practice disputes. However, each set of guidance has a different emphasis. The GFOA guidance emphasizes the importance of internal controls in reducing risks, such as establishing written investment guidelines, reporting requirements, and oversight systems. The NAST guidance focuses on the importance of communicating with pool participants, establishing the authorization to invest in certain types of products, and ensuring that investment policies exist—including borrowing and diversification policies. The RSWG guidance stresses the importance of risk management—including setting overall risk management objectives, valuing investments, and measuring risk-adjusted rates of return.

[14]GFOA's primary risk management guidance for end-users of derivatives was presented in GFOA Recommended Practice: Use of Derivatives by State and Local Governments (Washington, D.C.: June 7, 1994). GFOA also released other guidance related to these issues, including GFOA Recommended Practice: Diversification of Investments in a Portfolio (Washington, D.C.: 1997), and GFOA Recommended Practice: Sale of Derivative Instruments by State and Local Governments (Washington, D.C.: 1995).

[15]Guidelines for Local Government Investment Pools, NAST (Washington, D.C.: July 27, 1995).

[16]TMA was founded in 1979 and represents 7,000 members, consisting of cash management professionals, such as treasurers from the private sector. TMA seeks to educate, communicate, and recognize the treasury management profession.

[17]Voluntary Principles and Practices Guidelines for End-Users of Derivatives, TMA (Bethesda, MD: Oct. 1995).

[18]RSWG was established by 11 individuals from the institutional investment community to create a set of risk standards for institutional investment managers and institutional investors.

[19]Risk Standards for Institutional Investment Managers and Institutional Investors, RSWG (New York, NY: Nov. 1996).

The TMA guidance pays particular attention to end-user management controls, calls for end-users to obtain any necessary independent expertise, and provides an extensive list of disclosure standards and practices. Overall, RSWG and TMA provide the most detail on implementing their guidance.

Table 5.1: Key Elements of Various Organizations' Investment Guidance for End-Users

	Issuing organizations			
Element	**GFOA**	**NAST**	**RSWG**	**TMA**
Authority to use products	An analysis should be conducted to ensure that constitutional and statutory authority to execute derivatives contracts exists. End-users should also ensure that provisions against indebtedness and procurement statutes are not violated.	The end-user should prepare a written statement that provides legal authority for the investment pool and that establishes the relationship between pool managers and participants.	Fiduciary responsibilities of internal and external investment managers should be specified in writing and describe their authority to make investment decisions and capacity to enter agreements.	Policies should conform with regulations. The Procedures should address risks arising from derivatives use. Personnel authorized to enter transactions should be designated in writing.
Written investment policies	Purpose and objectives of derivatives use should be in writing. Policies should mandate sound asset and liability management and adequately consider safety, liquidity, and yield. The risk characteristics of products that might make them inappropriate for use should be considered, including their price volatility, liquidity, leverage, and valuation difficulty.	Written policies should address investment objectives and risks—with safety, liquidity, and yield as priorities. Policies should describe eligible products and strategies and any restrictions on such. They should also specify desired product and overall portfolio maturities, limits on amounts invested in each type of security, and extent to which borrowing can be used.	Written and approved policies should address investment philosophy, risk tolerance, and investment guidelines. Technical terms should be defined in writing and risk limits should be stated in concrete terms and updated as necessary. Back-up plans in the event of physical emergencies or financial crisis should be in writing. Risk policies should be consistently applied.	End-users should have written, board-established policies and objectives related to investment strategies, risk tolerances, and risk philosophy. Acceptable derivative products and strategies along with their objectives and goals should be specified.

(continued)

	Issuing organizations			
Element	**GFOA**	**NAST**	**RSWG**	**TMA**
Suitability of investments	Written acknowledgement should be obtained from dealers that they have received, read, and understood the end-user's debt and investment policies, including whether derivatives are authorized and the recommended product is suitable for the end-user. Entities should also be aware of when dealers are acting as agents or are taking a proprietary position and should evaluate potential conflicts of interest before entering transactions.	Dealers should follow the same standards of conduct as required for treasurers, and treasurers should obtain signed agreements of understanding from dealers that the investment alternatives being offered are suitable for the end-users' objectives.	In determining the appropriateness of investment strategies and instruments (1) investment strategies should be compared to the intent of compensation incentives and to written investment strategies; (2) contemplated activities should be compared to risk and return goals; (3) the impact of relevant risks on each instrument and the overall portfolio should be identified, measured, and understood; and (4) returns should be adjusted for risk to determine an instrument's relative performance.	Discussions should be held to ensure that employees involved with derivatives activities clearly understand applicable policies and procedures. In conducting daily operations, a transaction's potential to harm counterparty relations should be evaluated.
Reports on activities	End-users should regularly report derivatives use to governing bodies and make appropriate disclosures in official statements and other documents. End-users should also follow generally accepted accounting principles to report on derivatives use, hold early discussions with public accounting organizations on derivatives use, and use special reporting procedures, if necessary.	End-users should disclose to all pool participants and prospective participants their investment objectives, pool liquidity, and potential access limits to invested funds. Participants should also receive statements that assess and account for pool activities, including detailed reports of portfolio holdings, market values, and maturity as well as the independent auditor's report and opinion.	Requirements for routine reporting and deviation reporting should be defined. Also, procedures for reporting to higher management levels when deviations continue should be defined. Risk policies should be consistently applied and supported by management.	Relevant risks as well as risk management and other reporting policies and procedures should be established and should provide useful and relevant information. Financial statement disclosures and accounting should comply with industry regulations and standards. Disclosures should, at a minimum, discuss the types of derivative products used, the goals and objectives of their use, and the way their use is controlled.

(continued)

Element	Issuing organizations			
	GFOA	NAST	RSWG	TMA
Oversight and monitoring of transactions	Procedures should be established for periodic monitoring of derivatives use. Recordkeeping systems should be sufficiently detailed to allow governing bodies, auditors, and examiners to determine if use is in accordance with established objectives.	An independent advisory board should monitor investment activities of the investment manager for compliance with written objectives. An external audit of the investment function and treasury should be completed at least annually.	Oversight of line investment activities should be independent from oversight of compliance with risk policies using updated guidelines and control procedures. Roles, lines of responsibility, and reporting should be clearly written. Separation of responsibilities and adequate checks and balances should be in place. Evaluations of the validity and appropriateness of strategies, valuation methodologies, models, and systems should be conducted by an independent third party.	Systems and procedures for oversight should be established to (1) review legal relationships between counterparties to derivatives transactions and the derivatives transaction process, (2) periodically review compliance with policies and procedures, (3) identify and review policy changes, (4) identify deviations from written policies and procedures, (5) ensure compliance with accounting disclosure standards, and (6) review internal controls.
Pricing and valuation of transactions	Competitive price comparisons should be obtained before entering a transaction. End-users should be aware that little or no standardized pricing information is available for some products.	The portfolio should be marked-to-market at least monthly. Values should also be determined by an independent pricing service or by using multiple assessments to formulate an average. The method of valuation should be disclosed.	Products should be priced daily, weekly, or whenever feasible as well as whenever material events occur, using consistent and documented mechanisms and methodologies. More than one external source for pricing information should exist and internal pricing should be independently verified. Sources of valuation should be evaluated for incentives to inflate or deflate prices. Material differences in pricing between internal or external sources should be reconciled and the reasons reported and monitored.	Procedures and methods of valuing derivatives exposure and measuring current, potential, and underlying exposures; marking-to-market; dictating the frequency of valuing derivatives; and ensuring compliance with valuation procedures should be approved and established. End-users should not rely solely on one counterparty for valuation information but should have access to adequate internal or external expertise.

Sources: GFOA, NAST, RSWG, and TMA.

Some State Governments Acted to Reduce the Risk of Loss

Between 1994 and 1996, at least 14 states made changes that address the use of OTC derivatives, MBS, and structured notes by governmental entities within their states.[20] These actions—which included 11 states[21] enacting legislation and 3 states[22] making executive branch policy changes—were taken after governmental entities in some of these states incurred unanticipated losses from derivatives use. These actions were taken to minimize the risk of loss that product use poses to governments in at least one of three ways—by improving end-users' policies, procedures, and controls; limiting the use of certain types of products; or placing additional requirements on dealers.

One way that state governments have sought to decrease the likelihood of losses arising from the use of OTC derivatives, MBS, and structured notes was by requiring governmental entities to revise their own investment policies, procedures, and controls. Thirteen states took actions that place additional requirements on the investing entities within their states. For example, legislative bodies in Florida and Texas placed a similar new requirement on governmental units within their respective states to adopt investment plans that make the safety of investment funds a primary objective of government investment strategies. California and Florida now require their treasurer or unit carrying out the state's investment activities to follow the prudent investor/person standard.[23] Eleven states imposed requirements for strengthening internal controls on local governments. For example, Ohio now requires treasurers in local governments to establish and file written investment policies with the state, prepare quarterly investment reports, and provide monthly portfolio updates.

Several states also placed restrictions on the types of products that governmental entities could use. Ten of the 14 states now prohibit or restrict the use of OTC derivatives, MBS, and/or structured notes. For example, New Mexico now prohibits governmental entities in that state from using complex financial products, including structured notes. Wisconsin's legislation allows its state investment board to use derivatives

[20]In this section, we did not attempt to obtain comparable information from all states on any actions that may have been taken to improve investment policies, procedures, and practices. Instead, we summarized those that received broader public attention.

[21]These states were California, Colorado, Florida, Illinois, Kansas, Louisiana, Minnesota, Maryland, Ohio, Texas, and Wisconsin.

[22]These states were New Mexico and Oklahoma.

[23]The prudent person standard requires those investing on behalf of the governmental entity to act as a prudent person would be expected to act—with discretion and intelligence to seek reasonable income, to preserve capital, and in general, to avoid speculative investments.

only for reducing risk. In Florida, local entities can invest in derivatives if the entity's investment policy authorizes derivatives and if the entity's financial officers have sufficient expertise in managing derivatives investments.

Finally, four states also sought to place additional responsibilities on dealers marketing OTC derivatives, MBS, or structured notes to governmental entities in their jurisdictions as well as to impose punitive measures when violations are found. The four states—Colorado, Minnesota, Ohio, and Texas—require dealers to ensure that the products they offer are acceptable under the governmental entities' statutes or investment policies. For example, Texas requires broker-dealers to sign a statement acknowledging that they reviewed the entity's investment policy and implemented reasonable procedures and controls in an effort to preclude imprudent investment activities arising out of the subject transaction. Taking a different approach, Colorado law requires that dealers repurchase investments, for at least the original face value plus any accrued interest, if the investments are found to be impermissible for the governmental entity.

Regulators Have Improved Sales Practice Oversight of Regulated Firms, but Some Weaknesses Remain

Federal financial market regulators have improved their oversight of dealer sales practices, but have not taken certain steps that would better ensure dealers follow sound practices when marketing OTC derivatives, MBS, and structured notes. To limit the risks that these activities pose to regulated institutions, bank regulators have promulgated specific requirements for the marketing of financial products and conducted examinations to monitor the extent to which banks comply with them. As a result, bank supervisory guidance addresses sales practices more extensively than in the past. We also found that these regulators' examinations were generally thorough in addressing issues related to banks' sales practices for OTC derivatives, MBS, and structured notes. However, the Federal Reserve's guidance does not yet adequately address areas where weaknesses in a bank's practices could lead to sales practice-related losses, although agency officials told us the Federal Reserve plans to address these areas in updated guidance that the agency expects to issue by the end of 1997.

In contrast to banking regulators, the regulatory authority of SEC and CFTC does not extend to the unregulated affiliates of the firms they otherwise regulate. To address concerns about the risks these activities pose to the regulated entity, SEC and CFTC worked with the six U.S. securities firms whose affiliates did approximately 90 percent of all U.S. securities firm-related business in these products on the Framework for Voluntary Oversight. Under the Framework, the participating firms are to provide SEC and CFTC with more information about their unregulated activities; however, the two regulators are not to receive information that could be used to determine the extent to which the firms are following the sales practice provisions of the Framework. Finally, SEC relies primarily on the securities SROs to oversee the sales practices of MBS and structured note dealers. Although certain jurisdictional and other factors affected SROs' ability to fully assess dealers' sales practices, recent changes in the law and corresponding rules removed the most serious limitation affecting one SRO.

Bank Regulators' Efforts to Oversee Sales Practices Have Increased, but Updated Federal Reserve Guidance Has Not Yet Been Issued

Both the Federal Reserve and OCC have taken various actions to address sales practice issues. Both regulators issued guidance to their examiners and the banks they oversee that address the risks of marketing OTC derivatives, MBS, and structured notes. They subsequently conducted targeted examinations of bank sales practices for these products, including reviewing areas not adequately addressed in each agency's guidance. To ensure that subsequent examinations would also adequately review these areas, OCC issued additional guidance to address these weaknesses, but the Federal Reserve has not yet issued updated guidance. Federal Reserve officials told us they expect to issue revised guidance that will address the sales practice areas not specifically covered in their existing guidance by the end of 1997. In addition, the Federal Reserve placed specific sales practice-related requirements on one bank's transactions in certain types of complex OTC derivatives transactions as part of a 1994 enforcement action.

Bank Regulators Expanded Sales Practice Requirements for Banks

In 1993 and 1994, OCC and the Federal Reserve issued guidance to the banks they regulate. This guidance was also used by their examiners to review banks' activities. The two sets of supervisory guidance were designed to address the risks associated with the increasing volume of banks' activities in OTC derivatives and other financial products. According to OCC and Federal Reserve officials, before these issuances, sales practice-related guidance generally consisted of requirements that banks obtain sufficient information about a customer's financial condition and business activities before extending credit to or engaging in other financial transactions with the customer—referred to as the "know your customer" rule.

In expanding the treatment of sales practice issues, OCC and Federal Reserve guidance generally contained the same requirements to be followed by banks and used by bank examiners. Specifically, OCC guidance required that banks not recommend transactions that they know, or have reason to know, would be inappropriate for their customers on the basis of available information about the end-user. The Federal Reserve required banks to determine the sophistication of derivatives counterparties, including whether counterparties understood the nature and risks of transactions. In separate guidance to its examiners,[1] the Federal Reserve indicated that banks should establish standards to ensure that counterparties are not entering into transactions in complex products

[1]Trading Activities Manual, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System (Washington, D.C.: Mar. 1994).

where they do not understand the risks. The guidance also noted that bank management should be cognizant of the risks to the bank's reputation arising from its activities in these products. In December 1995, OCC issued additional guidance that more extensively discussed the risks—including compliance and reputation risks—that are associated with marketing financial products. This guidance also provided extensive criteria to help examiners evaluate the degree to which a bank was exposed to these risks and how well they were being managed.

Bank Regulators Generally Conducted Thorough Examinations After Sales Practice Problems Surfaced

In response to publicized sales practice disputes, OCC and the Federal Reserve conducted focused examinations of the largest bank dealers that addressed sales practices associated with OTC derivatives, MBS, and structured notes. In 1995, OCC conducted targeted examinations of several large bank dealers to assess their practices. OCC also published a summary of the results of these reviews, including identifying a list of best practices followed by the banks they reviewed. Similarly, the Federal Reserve targeted sales practices in examinations of major bank dealers conducted from mid-1994, when Bankers Trust's sales practice-related problems became public, to mid-1995. The scope of both regulators' examinations was broader than required by their existing supervisory guidance.

We reviewed the examination reports and supporting workpapers for seven of the targeted examinations that the two bank regulators conducted and found that these examinations were generally thorough in addressing key areas related to sales practices. As part of our review, we searched various sources for information applicable to sales practices—including securities regulators' examination materials, private risk management guidance, and case studies of end-user losses—and identified six elements that could comprise a thorough examination of an institution's sales practices. These elements include the existence of sales practice policies and procedures, management oversight and controls over marketing personnel, management oversight and controls over price quotes and valuation information, management supervision of restructured transactions,[2] policies and procedures for assessing counterparty sophistication and appropriateness, and adequacy of disclosures to counterparties. We found that OCC and Federal Reserve examiners had reviewed at least five of these six elements at each of the banks they examined. The element examiners most commonly omitted from review involved management supervision of restructured

[2]Restructured transactions are those in which the terms or conditions of an existing contract have been changed.

transactions. Also, the Federal Reserve's efforts focused primarily on more complex OTC derivatives transactions because agency officials believed that such transactions were harder for end-users to understand and value and thus were more prone to sales practice disputes.

OCC Addressed Weaknesses in Its Guidance, but Updated Federal Reserve Guidance Has Not Yet Been Issued

Although the guidance OCC and the Federal Reserve issued through 1996 expanded sales practice-related requirements, our analysis revealed that they did not address several sales practice areas related to compliance and reputation risks. These areas had been noted by regulators and dealers as among those in which sales practice disputes were likely to arise. For example, the guidance did not task examiners with assessing whether a bank's marketing practices might inadvertently create an advisory relationship with an end-user where none was intended. In addition, neither regulator directed its examiners to ensure that the banks had adequate internal controls in place related to supervisory review of the price quotations and position valuation information provided to end-users. The importance of assessing this aspect of a dealer's sales practices was illustrated by the Bankers Trust case, where providing incorrect price quotations and valuation information was the primary misconduct SEC and CFTC cited in their settlements with the bank. Finally, neither regulator's guidance required examiners to assess the accuracy of banks' marketing materials and product risk disclosures to end-users. Yet, both regulators reviewed such materials during the targeted examinations and found weaknesses.

In January 1997, OCC issued guidance to its examiners and the banks it oversees that expanded its coverage of sales practice issues into the areas where past problems were identified, thereby addressing these weaknesses. For example, the guidance directs OCC examiners to review any risk disclosure materials banks provide to customers and ensure that bank policies define the types of disclosures, if any, that should be made. Examiners are also to determine whether banks' internal audit staff ensure that sales presentations are clear, balanced, and reasonable. The guidance also raises expectations for banks' internal controls and supervision of marketing personnel, including requiring independent reviews of counterparty positions by other departments within the bank. Banks' policies must also provide guidance on avoiding the implication that an advisory relationship exists. Finally, the new guidance more specifically addresses the way transactions are to be documented, including directing that bank policies require the maintenance of financial statements, investment policies, and profiles of counterparties.

As of June 20, 1997, the Federal Reserve had not yet issued updated guidance, but agency officials told us that the agency expected to do so by the end of 1997. Federal Reserve staff provided us with a draft of the updated guidance to review. The planned revisions to the guidance would address the elements we identified as missing in the existing guidance.

The Federal Reserve Placed Higher Sales Practice Requirements on One Bank

Separately from the guidance issued to all of the banks that it oversees, the Federal Reserve tasked at least one bank with more stringent requirements as a part of a 1994 supervisory agreement. As discussed in chapter 3, some Banker's Trust counterparties raised concerns about the bank's marketing of OTC derivatives, which prompted regulatory investigations. As a result of its investigation, the Federal Reserve entered into a supervisory agreement with Bankers Trust that imposed extensive new requirements on some of the bank's activities in more complex OTC derivatives to increase the amount of information the bank provided on product risks as well as price and valuation calculations.

Specifically, the agreement included required practices for the bank's marketing of leveraged derivative transactions (LDT), whose payment flows and values are highly sensitive to changes in relevant market rates, prices, or indexes to which they are linked.[3] The agreement required Bankers Trust to (1) provide every counterparty with sufficient information about the terms and risks of any LDT it entered, (2) reasonably ensure that every counterparty has the ability to understand this information, and (3) conduct its LDT business in a manner that ensured reasonable price and valuation transparency to its counterparties.

The supervisory agreement also imposed specific disclosure obligations on the bank for proposed LDT transactions, including providing a written term sheet setting out material terms, explaining the risks, and preparing sensitivity analyses that show a broad range of potential outcomes. Both the term sheet and sensitivity analyses were to describe the various assumptions Bankers Trust used to evaluate transaction risks. To achieve reasonable price transparency, Bankers Trust was also to provide LDT counterparties with indicative (approximate) price quotes, which were to be updated daily for highly market sensitive LDTs and monthly for other

[3]See Written Agreement By and Among Bankers Trust New York Corporation, and Bankers Trust Company, and BT Securities Corporation, and Federal Reserve Bank of New York (FRB Docket No. 94-082), (Dec. 4, 1994). The agreement defines LDTs to include transactions where a market move of two standard deviations in the first month would reduce the value of a counterparty's position by the lower of 15 percent of the notional amount or $10 million, transactions where the counterparty's final principal payment is at risk, coupon swaps where the coupon can drop to zero or exceed twice the market rate, and transactions applying leverage (i.e., a multiplier) to rates or a spread between rates.

LDTs. Bankers Trust's procedures for achieving minimum risk disclosure and price transparency were to be subject to Federal Reserve review.

In addition to implementing these sales practice-related changes, Bankers Trust was subjected to a review of the conduct of its employees' LDT activities by a special counsel and was restricted from initiating any new LDT business until the Federal Reserve determined that it had complied with the provisions of the written agreement. On December 9, 1996, the Federal Reserve announced that it had terminated the written agreement, thus ending the heightened requirements and oversight placed on the bank. According to a press account, a Bankers Trust official responded by noting that the bank had implemented numerous policies and procedures over the prior 2 years that increased the transparency and controls related to activities with its derivatives customers.

Although the sales practice requirements outlined in this agreement were binding only on Bankers Trust, some industry participants, including legal experts and professional association officials, indicated that the agreement may have effectively set the standard for all derivatives dealers. However, a senior Federal Reserve official cautioned that requirements such as those placed on Bankers Trust for its LDT activities may not be appropriate for other OTC derivative products. This official told us that the detailed disclosures required of Bankers Trust for its LDT customers would be unnecessary for more experienced end-users of plain vanilla derivatives. However, she said that as the complexity of products increase, similar disclosures may become necessary.

Jurisdictional and Other Limitations Have Affected Oversight of Securities Firms' Sales Practices

SEC, CFTC, and the various industry SROs have increased their sales practice oversight of firms that deal in OTC derivatives, MBS, and structured notes. However, the approaches used to conduct this oversight were sometimes affected by these organizations' lack of authority over the full range of firms' marketing activities. Under legislation passed in the early 1990s, the firms under SEC and CFTC jurisdiction must provide SEC and CFTC, respectively, with information to be used in assessing the risks that such firms' unregulated activities, including those in nonsecurities and nonfutures OTC derivatives, pose to the regulated entity. To supplement this information, SEC and CFTC worked with the securities firms whose affiliates are most active in the OTC derivatives markets to develop guidance that includes actions these firms will voluntarily implement to manage their OTC derivatives risks, including those related to sales practices. By adopting the guidance, participating firms also agreed to provide additional information about their OTC derivatives activities. However, SEC and CFTC are not to receive information about the extent to which these firms are following the sales practice provisions of the guidance.

In contrast to nonsecurities OTC derivatives, SEC has jurisdiction over the marketing of MBS and structured notes[4] and has conducted examinations of dealers and taken enforcement actions against them for violations of the securities laws. SROs, such as NASD and NYSE, provide most of the routine oversight of dealers marketing these products and also have conducted examinations of and taken enforcement actions against dealers of these products. However, SRO efforts have sometimes been made more difficult by limits to their authority over particular firms or products. NASD faced the most serious restrictions, but recent changes to the law and applicable rules have removed these restrictions.

SEC and CFTC Jurisdiction Is Limited, but the Regulators Receive Information on Affiliates' Activities

As discussed in chapter 2, SEC and CFTC direct regulatory authority is limited to products defined as securities or futures (including certain options), respectively, and to the firms registered with these regulators to conduct such activities. Because nonsecurities and nonfutures OTC derivatives activities are usually conducted in affiliates outside of the direct oversight of these two regulators, neither regulator conducts examinations of these firms' sales of OTC derivatives.

To better assess the risk posed by the activities of these affiliates on the financial condition of a regulated broker-dealer, SEC was granted authority under the Market Reform Act of 1990 to collect certain types of information from the entities it regulates about their unregulated activities. CFTC was provided similar authority by the Futures Trading Practices Act of 1992. Both regulators subsequently issued risk assessment rules that require the firms subject to their regulation to submit additional information about their unregulated activities. For example, firms overseen by both SEC and CFTC provide these regulators with information on the total notional/contract amounts, aggregated credit risk exposure, and credit exposures concentrated by industry or counterparty arising from their OTC derivatives activities. The two regulators were to receive information from the regulated entities subject to these rules on a quarterly basis beginning in 1995. Firms regulated by both SEC and CFTC were to provide these regulators with descriptions of the systems they use

[4] As previously discussed, we assume for the purposes of this report that structured notes meet the terms and conditions of CFTC's hybrid exemption.

to manage the risks associated with transactions in nonsecurities OTC derivatives. SEC and CFTC officials confirmed that, in general, they have been receiving the information required under their rules.

SEC and CFTC Lack Information to Assess the Sales Practices of Unregulated Affiliates

The rapid growth of the OTC derivatives market and some highly publicized losses by end-users raised concerns by Congress and others about the potential risks that OTC derivatives use by unregulated affiliates might pose to the regulated entity and the financial system. SEC and CFTC responded by working with the six securities firms whose affiliates are most active in the OTC derivatives markets to develop the Framework, which includes a sales practice-related section (the provisions of which are discussed ch. 3). According to an SEC official, the affiliates of these six firms accounted for about 90 percent of the OTC derivatives activity done by securities firm affiliates.

To supplement the responsibilities that securities firms have under the risk assessment rules, the Framework expands the participating firms' commitment to taking additional voluntary steps related to their unregulated activities. These steps include reporting additional information to SEC and CFTC on their market and credit risk management systems and controls, risk in relation to the capital reserved against these activities, and credit concentrations and revenues from these activities. The Framework also outlines management controls that the firms are to follow. In addition, the firms have agreed to annual external audits whose purpose is to verify their adherence to the management control provisions of the Framework.[5]

Unlike the other aspects of the Framework, the provisions relating to sales practices are less prescriptive and do not call for SEC and CFTC to receive additional information on the firms' activities. These provisions suggest that participating firms (1) provide generic risk disclosure forms to new counterparties, (2) prepare accurate marketing materials that fairly present a transaction's benefits and risks, and (3) adopt internal controls sufficient to ensure that strong counterparty relationships are maintained. SEC officials told us that the agency had worked with the participating firms to ensure that the counterparty relationships section was included in the Framework because they believed that fair treatment of end-users is a prerequisite to the growth and evolution of the OTC derivatives market. In a

[5]Because its OTC derivatives affiliate is subject to oversight in the United Kingdom, CS First Boston is not subject to the additional reporting requirements but has committed to adhering to the other elements of the Framework. SEC officials told us that under SEC risk assessment rules, the agency receives copies of quarterly financial reports that the affiliate files with its U.K. regulator.

speech to end-users, an SEC commissioner said that the financial integrity of the OTC derivatives markets would be harmed if participants perceived them as unfair or rampant with abuse, thus, regulators have an interest in the sales practices used to market these products.

Although the firms agreed to external audits addressing their adherence to certain provisions of the Framework, as planned, these audits will not address the sales practices provisions. The Framework also does not stipulate that the participating firms report on the extent to which they are implementing the sales practice provisions of the Framework. For example, the participating firms have not provided copies of their sales practice policies—as they did as part of SEC's risk assessment process for their risk management systems—and descriptions of the internal controls they have established to ensure that such policies are being followed. In addition, the firms are not expected to periodically provide the regulators with internal audit reports that document adherence to these policies and controls. Without a mechanism to collect such information, SEC and CFTC will lack sufficient data to indicate whether these firms are conducting their OTC derivatives marketing activities in ways that foster the fairness and integrity of these markets as was envisioned by the agencies when the sales practice provisions were included in the Framework.

SEC Relies Primarily on SROs to Oversee MBS and Structured Note Dealers, but Also Conducts Examinations and Takes Enforcement Actions

Although SEC relies primarily on SROs to oversee the activities of MBS and structured note dealers, including their sales practices, it has an active regulatory program under which it receives reports on dealers' financial condition, examines broker-dealers and evaluates their compliance with laws and regulations, and conducts investigations of possible violations of the securities laws. The goals of its oversight are to (1) ensure the quality of SRO activities and (2) provide additional oversight of securities firms' marketing activities. For example, SEC conducted 645 examinations of securities firms in 1996, about 50 percent of which were to assess the quality of examinations performed by the relevant SRO. The remaining 50 percent of SEC examinations were initiated on the basis of a specific cause, such as a complaint by an end-user. SEC officials advised us that almost all of these examinations include some sales practice component. In conducting the 1996 examinations, the officials said that six examinations identified material sales practice deficiencies involving MBS or structured notes that were subsequently referred to SEC's Enforcement Division for investigation.

SEC is also expanding its examination procedures to address sales practice issues. According to officials in SEC's Office of Compliance Inspections and Examinations, new examination modules have been created to facilitate their examiners' review of products such as MBS and structured notes. Routine sales practice modules include updated steps to address current rules and case law regarding markups and confirmation disclosures, and specialized modules are being created for government securities. SEC is to use these specialized modules to review NASD's implementation of its new government securities rule (as discussed on p. 133).

Although SROs also conduct enforcement activities, SEC considers enforcing the securities laws to be one of its most important missions.[6] As discussed in chapter 3, SEC officials had initiated investigations against 24 dealers from 1993 through 1996 for deficiencies related to the sale of MBS and structured notes. In some of these cases, SEC has taken action against the dealer involved, including assessing monetary penalties, imposing operating restrictions, or revoking a dealer's license to conduct business. In several cases, both SEC and an SRO were investigating the conduct of the same dealer. A senior SEC Enforcement Division official explained that, when an SRO either has an investigation under way or has sanctioned a firm, SEC usually avoids initiating a parallel effort but sometimes will seek additional penalties for egregious cases. Decisions to pursue such actions also depend on the size and frequency of the violations and the dollar value involved. (See ch. 3 for a discussion of the results of SEC enforcement actions.)

Various Factors Also Affected SROs' Ability to Fully Assess Dealer Sales Practices

Securities industry SROs, particularly NASD and NYSE, are an integral part of the oversight of firms marketing MBS and structured notes. However, these organizations were not always able to review all of a dealer's sales activities. SROs can only review the sales activities of their members and not the sales activities of those firms' unregulated affiliates that are not also members. The way that certain customers use dealers of MBS and structured notes also reduced the SRO staffs' ability to fully assess sales practices for some transactions.

As part of their activities, NASD and NYSE have conducted examinations of securities firms. In 1996, NASD conducted 2,359 examinations and NYSE conducted 326 examinations that addressed sales practices, according to

[6]Similarly, CFTC considers enforcing the CEA to be one of its most important missions. Except for the Bankers Trust case previously discussed, we do not address CFTC enforcement actions in the OTC markets because they typically involved the illegal marketing of off-exchange futures, which is generally outside the scope of this report.

each SRO's statistics. SRO officials told us that the examinations generally reviewed firms' sales practice policies, procedures, and controls over marketing personnel. These organizations also had conducted enforcement investigations of possible sales practice violations, with NASD having performed investigations of 16 dealers and NYSE having performed investigations of 15 dealers from January 1993 through December 1996. (See ch. 3 for additional discussion of SRO enforcement action results.)

The way in which securities industry SROs conducted their sales practice oversight differed from the way they met their other responsibilities. According to a NYSE official, these SROs obtain reports and conduct examinations to ensure that their members are financially sound and in compliance with SRO rules and relevant federal securities law requirements. To facilitate these examinations and reduce the overlap of SRO jurisdiction over securities firms that conduct activities on multiple exchanges, usually just one SRO is designated to review the financial condition of such firms.[7] However, the NYSE official said that the individual SROs remain responsible for conducting their own examinations for sales practice purposes, unless they contract with another SRO to have such examinations conducted on their behalf.

Dealers' sales practice activities relating to OTC derivatives, MBS, and structured notes were not always subject to review by securities industry SROs. As previously discussed, the largest securities firms generally conduct their nonsecurities OTC derivatives activities in affiliates that are not registered with SEC. Although a dealer conducting activities in securities is required to join and submit to oversight by at least one securities industry SRO, its other nonsecurities affiliates, such as those conducting nonsecurities OTC derivatives activities, are not subject to SRO oversight.

The way that certain end-users conduct their activities in MBS and structured notes also affected SROs' ability to fully assess sales practices. NYSE officials told us that assessing the adequacy of their members' sales practices for MBS and structured notes could generally only be done when the customers involved are retail end-users. However, they estimated that such end-users account for only about 5 percent of the purchases of MBS. The remainder of such securities are purchased by institutional end-users that do not always maintain their holdings in accounts at NYSE-member securities firms. Instead, some transfer their purchases to custodial

[7] The SRO with responsibility for conducting the financial condition examination of a securities firm is known as its designated examining authority.

accounts at banks or other money managers. According to NYSE officials, reviewing an end-user's portfolio is an important way for them to determine the appropriateness and suitability of transactions for the particular end-user. However, the transfer of purchases by some institutional end-users to other accounts generally precluded NYSE staff from determining the appropriateness and suitability of transactions for such end-users.

Removal of Restrictions on NASD Oversight Should Improve Sales Practice Oversight

The most serious limitation on an SRO's ability to assess sales practices was faced by NASD. Before August 1996, NASD could not fully assess and take appropriate actions against certain deficiencies in the sales practices of dealers marketing GSE-issued MBS and structured notes, which accounted for the bulk of those securities issued.[8] As noted in chapter 2, NASD had been prohibited from applying its full complement of sales practice rules to the marketing of government securities by a long-standing provision in the Securities Exchange Act of 1934.[9] This restriction was removed by the Government Securities Act Amendments of 1993, and, after several rounds of public comment and revision, NASD obtained SEC approval to implement the rules and an associated interpretation on August 22, 1996.

While in effect, this restriction on NASD's authority affected its enforcement activities. In cases where NASD determined that dealers' sales practices warranted disciplinary action, the SRO was unable to pursue such cases as violations of its Rules of Fair Practice because GSE-issued securities were exempt from these rules.[10] Instead, it had to pursue the enforcement cases under the antifraud provisions of the securities laws. However, the burden of proof for fraud violations was harder to meet than that for noncompliance with SRO rules. The removal of restrictions on NASD authority will allow the SRO to pursue cases as violations of its own rules and should improve its ability to oversee sales practices for MBS and structured notes.

[8]NASD officials could not determine how many of their 5,000 members marketed GSE-issued securities; however, the officials indicated that in 1994 over 300 of the firms they oversaw held such securities and that most were probably offering them to end-users.

[9]This restriction did not extend to NYSE.

[10]As indicated in chapter 2, these rules are now known as Conduct Rules.

Conclusions and Recommendations

Conclusions

Although OTC derivatives are subject to sales practice requirements that vary, depending on the dealer or specific product involved, our survey found that most end-users of these products were generally satisfied with the sales practices of dealers with whom they did business. In addition, federal financial market regulators found that few dealers in these contracts were involved in sales practice disputes.

Certain characteristics of the OTC derivatives markets may explain the high level of end-user satisfaction and the relatively limited number of disputes. Specifically, our 1995 survey found that about 10 percent of a broad range of U.S. organizations had entered into plain vanilla OTC derivatives contracts and only 2 percent had entered into more complex OTC derivatives contracts. In addition, product use was concentrated among generally large, financially oriented organizations, with GSEs, finance companies, mutual funds, and money managers reporting the highest rates of usage.

Nonetheless, some regulators and market participants have responded to concerns about the losses and costly disputes that can arise when OTC derivatives sales practices are inadequate or when roles and responsibilities are unclear. Their responses have included issuing guidance on recommended practices and controls; strengthening sales practice or investment policies, procedures, and practices; and increasing internal reviews of these activities.

Although the President's Working Group on Financial Markets has concluded that legislation containing additional sales practice requirements is not currently needed for OTC derivatives, the market characteristics that contributed to the high level of end-user satisfaction and the limited number of sales practice disputes experienced to date could change as the markets evolve. These changes could include increased market participation by new dealers, more widespread use of complex products, or increased marketing to or product use by less sophisticated end-users. Such changes in market characteristics could cause the Working Group to reconsider whether current requirements are adequate to protect end-users of OTC derivatives or the financial markets.

However, the federal financial market regulators that participate in the Working Group do not routinely collect information related to changes in market characteristics. These regulators monitor the OTC derivatives activities of the firms subject to their respective oversight, and they discuss any developments of which they become aware through their joint participation in the Working Group. However, the regulators do not routinely collect the information necessary to ensure that they are able to systematically detect changes in market characteristics. Thus, the Working Group lacks a formal mechanism for obtaining the necessary information for monitoring market developments related to sales practices. Such a mechanism is important because it could alert the Working Group to the need for reassessing the adequacy of existing sales practice laws and regulations applicable to OTC derivatives.

Regarding MBS and structured notes, our survey found that end-user satisfaction with dealer sales practices was somewhat lower than for OTC derivatives. In addition, regulators identified more cases of potential sales practice abuse for these products than for OTC derivatives. However, SEC and the securities industry SROs have been investigating and, when deemed necessary, taking enforcement actions against the dealers involved in these cases. In addition, recently enacted rules subject dealers marketing GSE-issued MBS and structured notes—which account for the bulk of such securities—to all of NASD's sales practice requirements. The implementation of these rules should close what has been a major gap in regulatory oversight of these products and improve NASD's ability to ensure that dealer practices in these markets are appropriate.

Although the number of cases in which sales practice concerns were raised was relatively limited, the disputes that accompanied some of these cases resulted in both the end-user and dealer incurring significant costs. These costs included legal expenses, regulatory fines, reduced income, and even bankruptcy as well as other costs related to the failure to manage the compliance and reputation risks associated with these transactions. Although expanded sales practice requirements to protect end-users may not be necessary at this time due to the market characteristics previously discussed, the seriousness of these risks justify additional action by federal financial market regulators to better ensure the sound financial condition of regulated institutions and the fairness and integrity of the markets. Even actions that focus primarily on the risks posed to dealers can help improve dealer sales practices, benefit end-users, and enhance the overall integrity of the markets.

The Working Group could provide regulators a forum for assisting end-users and dealers in reconciling their differing views on the nature of their responsibilities in transactions involving OTC derivatives. According to our survey, over 50 percent of the end-users of plain vanilla OTC derivatives believed that dealers had certain fiduciary responsibilities to them in some or all cases. As reflected in the two sets of dealer-issued voluntary guidance—the Framework and the Principles—dealers have generally considered such transactions to be conducted at arm's length, with minimal responsibilities existing for either party beyond those of honest and fair dealing. To the extent that the differing views of end-users and dealers increase the likelihood of sales practice disputes that expose regulated institutions to material losses or that otherwise could prove disruptive to the markets, federal regulators have an interest in the reconciliation of these differences. The reconciliation of such differences does not entail federal regulators imposing a resolution on the markets. Rather, the type of relationship and accompanying responsibilities that should prevail in OTC derivatives transactions should be agreed upon by market participants.

A clearer understanding of the nature of end-user and dealer responsibilities may also be necessary for the voluntary standards to receive more widespread acceptance among end-users. In addition, these standards may be the only ones applicable to some unregulated market participants, such as insurance company affiliates. Therefore, by assisting market participants in reaching a clearer understanding of their responsibilities, federal financial market regulators may enhance the overall integrity of the markets. Reaching a clearer understanding may also encourage product use, where appropriate, by organizations that have limited their use because of concerns about transaction risks and uncertainty about the roles and responsibilities of dealers and end-users. Finally, reaching such an understanding could result in greater diligence by both end-users and dealers in ensuring that they comprehend product risks before entering into transactions.

Notwithstanding the potential benefits of an improved understanding between dealers and end-users, the issues surrounding their relationships are complex and federal involvement may not necessarily result in an agreement that is widely accepted. Even if an increased level of understanding between these groups could be reached, the likelihood of legal disputes when large losses occur might not decrease. However, federal financial market regulators would be justified in considering whether they can help end-users and dealers reach a mutually acceptable agreement because of the importance of these products to the financial markets and the U.S. economy. Consultation with market participants on this subject might assist regulators in assessing whether they should assume such a role.

Regardless of whether they decide to assist end-users and dealers in resolving their differences, federal financial regulators can take other specific actions to address the risks to dealers that market OTC derivatives, MBS, and structured notes. Although the Federal Reserve has conducted examinations of banks' activities and issued guidance on the responsibilities of banks that market these products, its guidance remains incomplete. Specifically, it does not direct bank examiners to assess the adequacy of bank policies and controls related to disclosing risk, acting in a fiduciary or advisory capacity, or supervising marketing personnel. Weaknesses in these areas existed in some cases where sales practice disputes have arisen. Although we found both bank regulators' examinations to be generally thorough, specifically addressing these areas in the Federal Reserve's guidance would better ensure that such areas receive similar attention in future examinations. Federal Reserve officials have efforts under way to update this guidance, and our review of a draft of this updated guidance indicates that it would address the elements we identified as missing in the existing guidance.

SEC and CFTC participation in the development of the Framework reflects their concern with the risks posed by the sales practices and other activities of the largely unregulated dealers in these markets. In lieu of additional regulation of this market, the Framework is to result in SEC and CFTC periodically receiving additional information, including the results of external audits, on some aspects of participating dealers' OTC derivatives activities. This information should improve the ability of SEC and CFTC to conduct the legislatively mandated risk assessments of the entities they regulate. However, information on these dealers' adherence to the sales practice provisions of the Framework is not included in the information these regulators are to receive. Adherence to these provisions is important for ensuring market fairness and integrity. In the absence of a mechanism for ensuring such adherence, SEC and CFTC cannot be sure that these firms' commitment to voluntarily follow the sales practice provisions of the Framework is being fulfilled, casting doubt on whether a voluntary arrangement is an adequate substitute for direct federal oversight.

Recommendations to the President's Working Group on Financial Markets

We recommend that the Secretary of the Treasury, as Chairman of the President's Working Group on Financial Markets, take the following actions:

- Ensure that the members of the Working Group establish a mechanism for systematically monitoring developments in the OTC derivatives markets to assess whether developments warrant introducing specific federal sales practice requirements.

- Lead the members of the Working Group in considering the extent to which it should assist end-users and dealers in reaching agreement on the nature of their relationship in transactions involving OTC derivatives.

Recommendation to the Federal Reserve

We recommend that the Chairman of the Federal Reserve Board implement planned revisions to the Federal Reserve examination guidance, which are to more specifically address the need to assess the adequacy of banks' policies and controls related to disclosing risks, creating advisory relationships, and supervising marketing personnel.

Recommendation to SEC and CFTC

We recommend that the Chairpersons of SEC and CFTC establish a mechanism for determining that participating firms are following the sales practice provisions of the Framework for Voluntary Oversight.

Agency and Industry Comments and Our Evaluation

We requested comments on a draft of this report from the heads, or their designees, of CFTC, the Federal Reserve Board, OCC, SEC, and Treasury. We also requested comments from two securities industry SROS (NASD and NYSE) and four industry associations (EUDA, GFOA, ISDA, and NASACT). Each of these agencies/associations provided us with written comments except CFTC, Treasury, and NASD. The Director of Treasury's Office of Federal Finance Policy Analysis provided oral comments on our recommendations. Officials from CFTC provided oral, technical comments. Our additional responses to written, nontechnical comments are contained in appendixes III through IX. Technical comments provided by CFTC, the Federal Reserve Board, OCC, SEC, Treasury, NASD, NYSE, EUDA, GFOA, and ISDA were incorporated into this report as appropriate.

Overall, no consensus emerged on the benefits of implementing our recommendations. The banking regulators and the associations that represent primarily end-users generally concurred with our findings and/or recommendations. The Federal Reserve also stated that this report makes a useful contribution to assessing the current state of financial market sales practices. OCC commented that the report is comprehensive in evaluating sales practices from the perspectives of dealers, end-users, and regulators. GFOA said this report will be an extremely helpful reference on derivatives, and NASACT stated that it provides an excellent study of sales practice issues facing the OTC derivatives market. In contrast, Treasury and

ISDA generally objected to our recommendations, with both opposing additional federal involvement in the OTC derivatives markets to address sales practice issues. SEC's views were mixed.

SEC, Treasury, and ISDA objected to our recommendation that the Working Group establish a mechanism for systematically monitoring developments in the OTC derivatives markets. Specifically, SEC and Treasury officials commented that the Working Group's current efforts, which generally include the principals meeting every 6 weeks and the staff meeting every 2 weeks, are adequate to address market developments. Similarly, ISDA commented that it is not readily apparent that a formal monitoring mechanism would be any more effective than the existing structure. In contrast, EUDA, GFOA, and NASACT supported this recommendation. EUDA indicated that taking the recommended steps—as they relate to this and our other recommendation to the Working Group—will lead to greater market safety and soundness, particularly concerning new dealers or end-users entering the markets. We continue to believe that the Working Group needs a formal mechanism for monitoring the OTC derivatives markets. As discussed in this report, the market characteristics that contributed to the relatively high level of end-user satisfaction and the relatively limited number of sales practice disputes could change as the markets evolve. This report recognizes that the federal financial market regulators monitor the OTC derivatives activities of the firms subject to their respective oversight, and they discuss market developments of which they become aware through their joint participation in the Working Group. However, this report also observes that the agencies that participate in the Working Group do not routinely collect the information necessary to ensure that they are able to systematically detect changes in market characteristics. Thus, the Working Group lacks a formal mechanism for obtaining the necessary information for monitoring developments related to sales practices. Such a mechanism is important because it could alert the Working Group to the need for reassessing the adequacy of existing sales practice requirements applicable to OTC derivatives. The information to be assessed could include the number and types of new dealers and end-users entering the markets, the types of complex new products being introduced, and changes in the types or sophistication of end-users to whom products are being marketed.

Treasury and ISDA also objected to our recommendation that the Working Group consider the extent to which it should assist end-users and dealers in reaching agreement on the nature of their relationship in transactions involving OTC derivatives. Treasury was concerned that, because such relationships are contractual, no single model may be appropriate. ISDA commented that no need exists for the Working Group to involve itself in mediating between dealers and end-users, that the involvement of market participants and regulators to date has been sufficient, and that the issues involved are complex and federal involvement may not result in an agreement that is widely accepted. In addition, ISDA stated that the draft report offered no evidence suggesting that disputes among privately negotiated derivatives contracts (that is, OTC derivatives contracts) are more frequent than in other commercial dealings, that these markets have been largely free of sales practice abuses, and that courts and regulators have not had difficulty in finding remedies when necessary. For these reasons, ISDA indicated that it did not support expanded regulatory activity. ISDA also commented that the report does not substantiate that the OTC derivatives market is "in any way broken and needs fixing," that our recommendations do not follow logically from the facts or conclusions in the report, and that our recommendations contradict the views of market participants and regulators.

SEC commented that in its efforts to address financial market issues, the Working Group has had discussions with end-users and professional counterparties (dealers) and that it believes the Working Group would be willing to continue this dialogue. However, SEC stated that it is not necessary for the government to intervene and define contractual obligations for professional and sophisticated counterparties. The Federal Reserve noted that it has recognized the importance of and encouraged voluntary industry efforts in this area, and the three end-user associations supported our recommendation.

We continue to support our recommendation that the Working Group consider assisting market participants in reaching agreement on the nature of their relationship in OTC derivatives transactions. This report acknowledges that the issues involved in reaching agreement between dealers and end-users are complex and may not lend themselves to a single, widely accepted solution. For this reason, we do not intend that the Working Group impose a model that defines counterparty relationships in OTC derivatives transactions. In addition, we do not base our recommendation to the Working Group on a finding that a high frequency of sales practice abuses exists or that courts and regulators have had difficulty in finding remedies when abuses occur. Instead, we present evidence that end-users and dealers do not always agree on the nature of their relationship, including their responsibilities, in OTC derivatives transactions. Although the dealer-issued voluntary guidance asserts that the nature of the relationship is arm's length, our survey found that a majority of end-users believed that dealers had fiduciary responsibilities in some or all OTC derivatives transactions, and that a majority indicated they relied on dealers from some to a very great extent as part of these transactions. To the extent that the differing views of end-users and dealers increase the likelihood of sales practice disputes that expose regulated institutions to material losses or that otherwise effect the sound financial condition of regulated institutions and the fairness and integrity of the markets, we concluded that the federal financial market regulators have an interest in the reconciliation of these differences.

Regarding ISDA's objection to additional regulatory activity, our report concludes that no legislation or regulation is currently needed. Nonetheless, our views on the benefits of federal regulatory involvement in the OTC derivatives markets differ from those of ISDA. In this regard, our recommendations address the need for the federal financial markets to fulfill their responsibilities related to ensuring the sound financial condition of regulated institutions and the fairness and integrity of the markets, without creating unnecessary or costly burdens for them. We do not recommend that the federal financial market regulators resolve the differences between dealers and end-users by defining the nature of their relationship for them. Rather, we recommend that they consider, as participants in the Working Group, whether the benefits of assisting market participants are sufficient to warrant their involvement and whether their involvement is likely to achieve the desired result. The Working Group's assistance could involve facilitating discussions between dealers and end-users that lead to agreement in key areas where they now disagree. Regarding ISDA's comment that our recommendations contradict the views of market participants and regulators, this report recognizes the varying support of these parties for our recommendations.

Treasury officials commented that the draft report appeared to be critical of establishing an arm's-length relationship as the default model for OTC derivatives transactions. ISDA officials supported the arm's-length relationship as the default model, noting that it is the appropriate starting place for institutional market participants. This report does not reach a conclusion on the appropriate default model for counterparty relationships. It presents the views of both those who support and oppose an arm's-length relationship as the default model. As clarified in chapter 7, we conclude that the type of relationship and accompanying responsibilities that should prevail in OTC derivatives transactions should be agreed upon by market participants, and we recommend that the

Working Group consider assisting market participants in reaching agreement on these issues.

The Federal Reserve commented favorably on our recommendation to its chairman. That is, the agency indicated that it has efforts under way that would fully respond to our recommendation that the agency revise its examination guidance to more specifically address the need to assess the adequacy of banks' policies and controls related to disclosing risk, creating advisory relationships, and supervising marketing personnel.

In addressing our recommendation that SEC and CFTC establish a mechanism for determining that participating firms are following the sales practice provisions of the Framework, SEC indicated that it is willing to discuss with the affected parties the feasibility of extending the external auditor's role to incorporate a review of sales practice procedures. This appears to be an appropriate first step towards implementing our recommendation. As indicated in chapter 6, SEC and CFTC could also request that the participating firms provide copies of their sales practice policies—as was done for these firms' risk management systems as part of SEC's risk assessment process—and descriptions of the internal controls these firms have established to ensure that such policies are being followed. CFTC did not comment on this recommendation.

However, NASACT opposed this recommendation to SEC and CFTC, contending that these agencies' participation in a compliance program would be recognized as an endorsement of the Framework and would present new legal obligations without first being subject to the due process associated with a new regulation. In place of our recommendation, NASACT proposed that the drafters of the Framework and end-users work with SEC and CFTC to further clarify counterparty relationships. GFOA also expressed concern that the dealer-issued voluntary guidance could establish legal obligations, noting that Bankers Trust cited the Principles as support in legal actions involving Procter & Gamble.

Our recommendation is not intended to create new legal obligations for dealers or end-users. Regarding NASACT's concern that SEC and CFTC participation in a compliance program related to the Framework would present new legal obligations (presumably for end-users), this report notes that the Framework is not intended to apply to end-users. Instead, the Framework specifically states that it applies only to the participating firms and only to their nonsecurities OTC derivatives activities. Although the

Framework indicates that it is not intended to create legally enforceable obligations, this report acknowledges that the courts could find the guidance useful in evaluating counterparty relationships and defining common law responsibilities. To the extent that market participants find this potential outcome objectionable, they can individually take steps to clarify their relationship with counterparties in each transaction they enter.

We believe that a more effective approach would be for end-users and dealers to participate in a joint effort to reach agreement on the nature of their relationship in OTC derivatives transactions, and we have recommended that the Working Group consider assisting the parties in this process. We make our recommendation to the Working Group in the belief that a coordinated effort by the federal market regulators would be a more effective means of reaching agreement on the nature of counterparty relationships, including the responsibilities of counterparties to OTC derivatives transactions. An additional advantage to this approach is that the resulting agreement would not make distinctions between types of dealers and end-users. That is, it would not distinguish between dealers that are banks and dealers that are securities firm affiliates or their end-user counterparties. As a result, should the Working Group assist dealers and end-users in reaching an agreement on the nature of their relationship, the resulting agreement would be applicable to all dealers and end-users of OTC derivatives.

This report also notes that, in lieu of additional regulation, SEC and CFTC are already participating with the drafters of the Framework in a voluntary program that includes monitoring the nonsales practice provisions of the Framework by external auditors. We are merely recommending that such monitoring be extended to the sales practice provisions of the Framework. As we conclude in this chapter, adherence to these provisions is important for ensuring market fairness and integrity. In the absence of a mechanism for ensuring such adherence, SEC and CFTC cannot be sure that a participating firm's commitment to voluntarily follow the sales practice provisions of the Framework is being fulfilled, thereby casting doubt on whether a voluntary arrangement is an adequate substitute for direct federal oversight.

Methodology for GAO Survey of End-Users

Beginning in March 1995, we sent questionnaires to 2,381 randomly selected organizations drawn from a wide range of U.S. public and private industries, representing a universe of approximately 49,000 organizations that were potential end-users of plain vanilla over-the-counter (OTC) derivatives, complex OTC derivatives, structured notes, and asset-backed securities.[1] Our objectives in conducting the survey were to estimate for these four product types (1) the extent of end-user satisfaction with dealer sales practices and (2) the extent of product use.

The questionnaire requested data on the usage of specific products within the 12 months preceding receipt of the survey. It also asked respondents to rate the sales practices of any dealers with whom they engaged in transactions across six dimensions: (1) disclosure of downside risks, (2) quality of transaction documentation provided, (3) suitability of products proposed, (4) competitiveness of pricing and fees, (5) provision of accurate mark-to-market pricing information, and (6) assistance in unwinding transactions. In addition, it asked the organizations to separately rate the sales practices of dealers that proposed contracts, but who they did not use, over the three applicable dimensions listed above—(1), (3), and (4). We developed these sales practice dimensions on the basis of reviews of regulatory and dealer documents and discussions with regulators, dealers, and end-users. Lastly, the questionnaire asked organizations to provide overall ratings of sales practices both for dealers with whom the organizations entered into contracts as well as dealers that proposed contracts but who they did not use.

From the returned surveys, we selected a judgmental sample of 70 of the respondents, drawn from a wide spectrum of large and small organizations across all of the industries surveyed. Some were end-users and others were nonusers of the four types of products; some were satisfied with dealer sales practices, while others were dissatisfied. We completed telephone follow-up interviews with 50 of these respondents to learn more about the reasons for their satisfaction or dissatisfaction with dealer sales practices, their opinions on fiduciary relationships, and the range of end-user sales practice-related policies, procedures, and practices. Although the results of these follow-up interviews are not generalizable to any larger population of potential end-users, the 50 organizations contacted generally reflect the range of organization types and sizes, product usage, and satisfaction levels.

[1]We included mortgage-backed securities as a subset of asset-backed securities in the questionnaire.

Design of the Survey Sample

To respond to a request made by the former Chairman of the Subcommittee on Telecommunications and Finance, House Committee Energy and Commerce, we set out to determine the extent of end-user satisfaction with the sales practices of dealers offering OTC derivatives, mortgage-backed securities (MBS), and structured notes across a wide universe of U.S. public and private organizations that might be using these products, including not only the organizations with the largest finances, but also the smaller organizations in each industry. The former Chairman also asked us to determine the extent of product use.

To obtain a statistically precise estimate (one with a low sampling error) of the level of satisfaction with dealer sales practices, we needed to collect as many survey responses as possible from current end-users, which are more likely to have experienced sales practice presentations. Our prior work and that of other organizations indicated that larger organizations tend to be end-users of these products more often than smaller organizations.

However, we were concerned that smaller organizations, which might use these products less often and have fewer resources for managing their financial activities, might have different sales practice experiences than larger organizations. Any such differences would not be reflected by our estimate of the level of satisfaction, if small organizations were excluded from the survey. Also, we did not want to exclude from our estimate of usage a significant number of smaller organizations that had at least some, if limited, potential for being end-users. Therefore, to obtain unbiased estimates of satisfaction and usage, we included proportionately more large organizations in our sample, while still selecting some organizations that would represent the smaller entities in the population under study.

We began by defining the populations we would survey. We identified 19 public and private industries that we concluded would thoroughly cover potential end-users. For each of the 19 survey strata representing these industries, we had to compile a frame, or a listing of all known organizations in a population, ideally without duplicates or omissions. The frames had to include mailing addresses, relevant contact names, and enough information about the organizations to allow classification by industry and financial size and to allow the assignment of a unique identification number. In several of the industries we surveyed, our frames did not cover all of the known organizations, but were restricted to organizations above a minimum financial size, determined by the availability of data in the lists we used. Nevertheless, the scope of each frame covered a significant proportion of the smaller organizations in that industry and adequately comprised the population of organizations that would have a reasonable probability of derivative product usage and experience with dealer sales practices. See table I.1 for a description of the 19 industry strata, the scope of organizations included in those strata, and the sources for the sample frames we developed to represent those populations.

Table I.1: Design of Potential End-User Sample Frame

Strata (19)	Population definition	Frame used	Indicators of size and/or usage	Size/Usage substratification criteria
Cities and counties	All 38,995 local governments, such as counties, municipalities, and townships, that were identified in a 1987 census and updated by subsequent annual surveys (excludes states).	Directory of Governments, 1988: Name and Address File (U.S. Bureau of the Census).	Population counts from 1990 decennial census.	Large substratum defined as organizations in top 5 percent, representing 70 percent of total population count. Small substratum consists of all other organizations.
Special districts	All 32,838 local government special districts or authorities, such as airports, hospitals, utilities, ports, and terminals.	Directory of Governments, 1988: Name and Address File (U.S. Bureau of the Census).	Population counts of cities in which the districts are located, from 1990 decennial census.	Large substratum defined as the special districts (except sewerage and water supply districts nationwide and other multifunction districts in Texas) with addresses in the 30 most populous cities. Small substratum consists of all other organizations.
Local school districts	All 14,222 school districts and systems.	Directory of Governments, 1988: Name and Address File (U.S. Bureau of the Census).	School enrollments from the 1992-93 school year.	Large substratum defined as organizations in the top 10 percent, representing 60 percent of total school enrollment. Small substratum consists of all other organizations.
State treasuries	Offices of all 50 state treasurers and the District of Columbia.	Various government directories.	Not applicable.	No substratification.
Private pension funds and union funds	All 46,795 corporate and union (headquarters and local) pension funds with investment assets of $1 million and over that were identified in a periodic review of Department of Labor Form 5500 filings (Annual Return/Report of Employee Benefit Plan) and a proprietary survey conducted by Money Market Directories, Inc.	1995 Money Market Directory Pensionscope Database (Money Market Directories, Inc.).	Total pension assets.	Large substratum defined as organizations with $20 million in pension assets and over, representing approximately the top 10 percent of organizations. Small substratum consists of all other organizations.

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Strata (19)	Population definition	Frame used	Indicators of size and/or usage	Size/Usage substratification criteria
Public pension funds and retirement systems	All 1,167 pension funds and retirement systems sponsored by state, county, and municipal governments with investment assets of $1 million or more, identified and updated periodically by Money Market Directories, Inc.	1995 Money Market Directory Pensionscope Database (Money Market Directories, Inc.).	Total pension assets.	Large substratum defined as organizations with $1 billion in pension assets and over, representing approximately the top 10 percent of organizations. Small substratum consists of all other organizations.
Endowments and foundations	All 4,855 private educational and museum funds; private and public charitable endowments; and foundations with assets of $1 million or more, identified and updated periodically by Money Market Directories, Inc.	1995 Money Market Directory Pensionscope Database (Money Market Directories, Inc.).	Total assets.	Large substratum defined as organizations with $100 million in total assets and over, representing approximately the top 10 percent of organizations. Small substratum consists of all other organizations.
College and university operating funds	All 3,667 2-year and 4-year U.S. colleges, universities, technical institutes, and vocational programs, identified by Department of Education surveys, conducted annually.	Digest of Education Statistics, 1994 (National Center for Education Statistics).	Current-fund revenues, as reported for the 1991-92 period.	Large substratum defined as organizations with $80 million and over in current-fund revenue for the 1991-92 reporting period, representing approximately the top 10 percent of organizations. Small substratum consists of all other organizations.
Institutional money managers	All 1,759 registered U.S. investment advisor firms, bank and trust departments, and insurance companies managing various assets of at least $1 million, identified and updated periodically by Money Market Directories, Inc.	1995 Money Market Directory Pensionscope Database (Money Market Directories, Inc.).	Total managed assets.	Large substratum defined as organizations with $1 billion in managed assets and over, representing approximately the top 36 percent of organizations. Small substratum consists of all other organizations.

(continued)

Strata (19)	Population definition	Frame used	Indicators of size and/or usage	Size/Usage substratification criteria
Government-sponsored enterprises (GSE)	All 33 GSEs and GSE-like organizations that we identified as being in existence in March of 1995, including major credit organizations, such as the Federal National Mortgage Association and the Federal Home Loan Mortgage Association, regional Federal Home Loan Banks, Farm Credit Banks, and other organizations with the Standard Industrial Code (SIC) classification of 6111 ("Federal and Federally Sponsored Credit"). Excludes approximately 238 Farm Credit Associations whose day-to-day asset or liability management is generally carried out at the bank level or higher.	Ward's Business Directory, (1994 edition); previously published GAO products, and consultation with GAO experts.	Not applicable.	No substratification.
Commodity pools	Includes 844 commodity pools with U.S. operators, with total net asset value of $1 million or more, as of January 1995, according to National Futures Association records.	National Futures Association.	Net asset value of pool, as of January 1995.	Large substratum defined as organizations with $31.5 million net asset value and over, representing approximately the top 33 percent of organizations. Small substratum consists of all other organizations.
Mutual funds	All 6,358 individual equity and bond mutual funds (except for municipal bond funds), identified by Lipper Analytical Services, Inc., as of January 1995.	Lipper Analytical Services, Inc.	Total net assets under management.	Large substratum defined as organizations with $450 million in total net asset value and over, representing approximately the top 10 percent of organizations. Small substratum consists of all other organizations.
Money market funds	All 1,237 taxable and tax-exempt money market mutual funds, including municipal bond funds, identified by Lipper Analytical Services, Inc., as of January 1995.	Lipper Analytical Services, Inc.	Total net assets under management.	Large substratum defined as organizations with $1.15 billion net asset value and over, representing approximately the top 10 percent of organizations. Small substratum consists of all other organizations.

(continued)

Strata (19)	Population definition	Frame used	Indicators of size and/or usage	Size/Usage substratification criteria
Publicly held nonfinancial corporations	The 5,581 U.S. parent companies with at least 500 stockholders of one class of stock, at least $5 million in assets, and filing reports with the Securities and Exchange Commission in the 18 months before the 1994 review by Compact Disclosure. Excludes companies listed in Compact Disclosure on the basis of a debt issue and not traded on a national or regional exchange, or on the National Association of Securities Dealers Automated Quotation system, and which had sales of less than $25 million. Also excludes companies with a primary SIC in the financial industry and foreign-based companies with American Depository Receipts listed on U.S. stock exchanges.	Compact Disclosure (Disclosure, Inc.) and the March 14, 1995, Pink Sheets (National Quotation Bureau, Inc.).	Total annual sales figure most recently reported in Compact Disclosure records.	Large substratum defined as organizations with $1.4 billion annual sales and over, representing approximately the top 10 percent of organizations. Small substratum consists of all other organizations.
Privately held nonfinancial corporations	The 8,204 U.S.-based nonfinancial privately held ultimate parent companies with annual revenues of at least $10 million or a workforce of at least 300 people as listed in the 1994 Directory of Corporate Affiliations, Volume 5—U.S. Private Companies. Excludes public organizations and companies with a primary SIC in the financial industry.	1994 Directory of Corporate Affiliations, Volume 5—U.S. Private Companies (National Register Publishing) and Ward's 1995 Business Directory of U.S. Private and Public Companies (Gale Research, Inc.).	Total sales as reported in Ward's 1995 Business Directory of U.S. Private and Public Companies.	Large substratum defined as the top 200 corporations in total 1994 sales, representing approximately the top 2 percent of organizations in the population. Small substratum consists of all other organizations.

(continued)

Strata (19)	Population definition	Frame used	Indicators of size and/or usage	Size/Usage substratification criteria
Largest nonbank financial corporations	The largest 120 firms with assets over $100 million, as identified by Ward's 1995 Business Directory. Includes financial companies other than banks, insurance companies, and securities firms. Includes firms classified under the following SICs: 6141, personal credit institutions; 6153, short-term business credit firms; 6159, miscellaneous business credit firms; 6162, mortgage bankers and correspondents; and 6163, loan brokers. Does not include subsidiaries of banks or thrifts but may include subsidiaries of insurance or nonfinancial companies.	Ward's 1995 Business Directory of U.S. Private and Public Companies (Gale Research, Inc.).	Total assets as reported in Ward's 1995 Business Directory of U.S. Private and Public Companies.	No substratification.
Banks and thrifts	All 9,816 U.S. thrifts and single-bank and multibank holding companies or lead banks with national or state charters. Does not include New York Investment Companies or trust companies. Branches, subsidiaries, or individual banks that are members of larger families of banks are also excluded.	Holding company, bank, and thrift data files in June 1994 (#188) Call Report (Federal Financial Institutions Examination Council).	Total assets as reported in June 1994 Call Reports and total dollar amount of assets and liabilities reported in all categories of MBS, either held to maturity, available for sale, or held in trading accounts plus total off-balance sheet notional value dollar amounts of various interest rate and foreign exchange forwards, options, and swaps.	Largest substratum defined as those institutions with total assets of $225 million or more and reporting $300 million or more in holdings of MBS and notional amounts of forwards, options, and swaps (3 percent of the population). Middle substratum defined as institutions with total assets of less than $225 million and reporting $300 million or more in holdings of MBS and notional amounts of forwards, options, and swaps and institutions of any asset size and reporting up to $300 million in holdings of MBS and notional amounts of forwards, options, and swaps (33 percent of the population). Smallest substratum defined as institutions of any asset size reporting no holdings of these products (64 percent of the population).

(continued)

Strata (19)	Population definition	Frame used	Indicators of size and/or usage	Size/Usage substratification criteria
Insurance companies	The 2,523 ultimate parent property/casualty and life/health insurance companies identified in the 1994 edition of Best's Insurance Reports. Includes foreign-owned U.S. subsidiaries or divisions that list their U.S. executive management in Best's Insurance Reports. Also includes insurance companies owned by holding companies outside of the insurance industry. Does not include subsidiaries or divisions of other U.S. insurance companies.	Best's Insurance Reports, 1994 edition (A.M. Best, Inc.).	Total assets as reported in 1994 edition of Best's Insurance Reports.	Large substratum defined as organizations with $700 million in assets and over, representing approximately the top 12 percent of organizations. Small substratum consists of all other organizations.
Credit unions	All 13,380 federally insured corporate and natural person credit unions in the United States. Includes the U.S. Central Credit Union. Natural person credit unions primarily serve individuals who are their member-owners. Corporate credit unions are cooperatively owned by the natural person credit unions and serve them by investing a portion of their assets or loaning them funds for liquidity purposes.	Data tapes from the National Credit Union Administration.	Total assets in 1994. Also, total holdings of collateralized mortgage obligations (CMO) and real estate management investment conduits (REMIC) in June 1994.	Largest substratum defined as all 45 of the corporate credit associations, 25 of which reported holding CMOs or REMICs as of December 1994 (less than 1 percent of the population). Second substratum defined as the 1,147 natural person credit unions with any CMO or REMIC holdings as of June 1994 (approximately 9 percent of the population). Third substratum defined as the 1,204 natural person credit unions with no CMO or REMIC holdings as of June 1994, but with $50 million or more in assets (approximately 9 percent of the population). Fourth substratum defined as the 10,984 natural person credit unions with no CMO or REMIC holdings as of June 1994 and less than $50 million in assets (approximately 82 percent of the population).[a]

[a]Totals do not sum to 100 percent due to rounding.

Source: GAO.

After identifying the 19 strata representing broad industries, we then subdivided 16 strata into 2 or more substrata on the basis of financial size and, if available, the extent of past product usage. We did not subdivide three strata—state treasuries, GSEs, and the largest nonbank financial corporations—because they were already narrow industries with too few organizations to subdivide by size. We substratified to group organizations on the basis of how likely they were to be current end-users of OTC derivatives, MBS, and structured notes so that we could sample them at different rates. In each of the industry strata, we chose indicators of financial size, such as annual revenues, assets under management, or population in the governmental jurisdiction served. For the bank and credit union strata, additional information identifying past users of certain kinds of products was available from financial reports.

Typically, we defined the larger substrata in each industry as the top 10 percent of the number of organizations in the population when ranked by size, although the cutpoints defining the large substrata varied from approximately the top 1 percent to 33 percent of some populations, depending on our knowledge of that particular industry or the characteristics of the sampling frames (see table I.1). For example, we defined the large credit union substratum as only the corporate credit unions, which covered less than 1 percent of all credit unions. Corporate credit unions, which tend to be large, differ in structure and function from smaller "natural person" credit unions. In addition, we defined a cutpoint of $1 billion in assets under management for money managers, resulting in the large substratum covering 36 percent of the organizations in the population, because that asset level was the highest available in the computerized list that we used. Organizations known to have recently used certain MBS and derivatives were included in the larger substrata of banks, thrifts, and credit unions.

The sample was drawn from each substratum at different rates—proportionately more organizations were drawn from the substrata of large entities and recent users, which we expected to yield a relatively high proportion of current users, and fewer from the substrata of smaller entities, which we expected to yield fewer end-users. This differential rate of sampling was necessary to obtain a sample that would meet both the objectives of developing an acceptable estimate of overall usage and an acceptable estimate of users' opinions. See table I.2 for the exact allocation of the original survey sample of 2,422 organizations[2] across the

[2]Of the 2,422 organizations in the original sample, 41 were determined to be ineligible (out of business, wrong industry, duplicate listing, and similar dispositions) before mailout. From the 2,381 questionnaires mailed out, we determined that an additional 177 organizations were ineligible during the course of the survey. The final working sample size was 2,204 organizations.

substrata and the aggregation of the 19 strata into the 9 industry groups that we used to present our findings throughout this report.

Questionnaire Design

To develop our questionnaire, we consulted representatives of the dealer community, groups representing end-users, financial regulators, and other finance experts. We also conducted many in-depth interviews with finance officers from state and local governmental entities and private corporations on subjects to be included in the questionnaire. After drafting a questionnaire and receiving comments from the aforementioned groups, we conducted five pretests of the questionnaire with a variety of likely respondents drawn from several of the survey populations. The information gathered during such tests was used to improve the structure of the questionnaire as well as the phrasing of specific questions.

Survey Administration

The mailout of questionnaires began during the last week of March 1995. Follow-up mailings with replacement questionnaires and a renewed appeal encouraging response were sent to nonrespondents beginning in the last week of May 1995. In the second week of July 1995, we began to make telephone follow-up calls to a sample of organizations that had not yet responded to either the first or second questionnaire mailing. A random sample of approximately 50 percent of the nonrespondents was drawn from across all of the strata, and we administered a short telephone interview questionnaire to that sample of 365. The follow-up interviews determined the reason for nonresponse, prompted the return of the full questionnaire, or collected basic data from the organization if a mail questionnaire would not be returned by the respondent. The survey was closed out at the end of October 1995, after which no additional responses were included in our results. Because the questionnaire asked for product usage and sales practice experience for the 12 months preceding the survey, and given that respondents were filling out and returning questionnaires from April 1995 through October 1995, the maximum possible period of financial activity covered by the survey was from April 1994 through October 1995.

Survey Response

We attempted to collect data from every one of the organizations chosen in our random sample. However, for a variety of reasons, such as refusals, we did not receive usable responses from a number of entities. After sending a replacement questionnaire to nonrespondents and following up by telephone with a random sample of the remaining nonrespondents, we determined the final status of our entire sample (see table I.2). We received 1,755 usable responses, for an overall response rate of 80 percent. Although some of the survey strata exhibited higher or lower rates of response than others, the response rates did not vary systematically by size of stratum. Because we hypothesized that large and small organizations would differ on key variables, a large difference in response rates between large and small substrata could have introduced bias into the overall survey results.

Table I.2: Disposition of Survey Sample Across All Strata

Industry groups (9)	Strata (19)	Substrata (38)	Original population	Original sample	Ineligible
State and local government	Cities and counties	Large: population ≥ 37,000	1,932	100	1
		Small: population < 37,000	37,104	50	5
	State and local special districts	Large: top 30 urban areas	489	50	5
		Small: all other districts	32,349	50	4
	Local school districts	Large: enrollment ≥ 5,250	1,426	50	0
		Small: enrollment < 5,250	12,796	50	0
	State treasuries	All states and District of Columbia	51	51	0
Pension funds	Private pension/Union funds	Large: assets ≥ $20 million	4,407	100	3
		Small: assets < $20 million	41,349	100	5
	Public pension funds/Retirement systems	Large: assets ≥ $1 billion	123	75	1
		Small: assets < $1 billion	1,044	25	0
Endowment and college funds	Endowments and foundations	Large: assets ≥ $100 million	507	50	3
		Small: assets < $100 million	4,348	50	1
	College and university operating funds	Large: revenue ≥ $80 million	366	50	3
		Small: revenue < $80 million	3,301	50	1
Money managers	Institutional money managers	Large: assets ≥ $1 billion	637	122	0
		Small: assets < $1 billion	1,122	72	3
GSE	GSE	All	33	33	1
Investment funds	Commodity pools	Large: net asset value ≥ $31.5 million	286	29	7
		Small: net asset value < $31.5 million	558	26	0
	Mutual funds	Large: assets ≥ $450 million	636	125	3
		Small: assets < $450 million	5,722	75	1
	Money market mutual funds	Large: assets ≥ $1.2 billion	124	75	0
		Small: assets < $1.2 billion	1,113	75	5
Nonfinancial corporations	Publicly held nonfinancial corporations	Large: sales ≥ $1.4 billion	506	75	0
		Small: sales < $1.4 billion	5,075	74	1
	Privately held nonfinancial corporations	Large: top 200, by sales	200	50	3
		Small: all others	8,004	121	16

Respondents	Nonrespondents	Follow-up sample	Follow-up ineligible	Follow-up respondents	Follow-up nonrespondents	Total responses	Response rate (percent)
67	32	10	6	4	0	71	76
45	0	0	0	0	0	45	100
23	22	7	5	2	0	25	63
29	17	14	5	8	1	37	90
34	16	7	0	6	1	40	80
34	16	6	1	4	1	38	78
32	19	5	1	4	0	36	72
54	43	17	3	11	3	65	69
63	32	18	4	11	3	74	81
60	14	8	2	5	1	65	90
16	9	4	2	2	0	18	78
32	15	10	3	4	3	36	82
38	11	7	1	5	1	43	90
37	10	6	1	5	0	42	91
35	14	10	4	2	4	37	82
70	52	32	12	11	9	81	74
64	5	0	0	0	0	64	93
31	1	0	0	0	0	31	97
18	4	0	0	0	0	18	82
13	13	7	4	2	1	15	68
58	64	22	5	12	5	70	60
36	38	27	3	21	3	57	80
36	39	17	0	14	3	50	67
28	42	32	15	10	7	38	69
46	29	12	3	7	2	53	74
42	31	12	2	9	1	51	72
33	14	7	5	2	0	35	83
70	35	11	4	7	0	77	76

(continued)

Industry groups (9)	Strata (19)	Substrata (38)	Original population	Original sample	Ineligible
Other financial corporations	Largest nonbank financial corporations	Top 120, by assets	120	120	7
Banks/ Credit unions/ Insurance companies	Banks and thrifts	Large/Past users: MBS and derivative usage ≥ $300 million and assets ≥ $225 million	309	75	2
		Medium/Past users: (1) usage < $300 million or (2) usage ≥ $300 million and assets < $225 million	3,194	75	1
		Small/No past usage: $0 usage, any asset size	6,313	50	10
	Insurance companies	Large: assets ≥ $700 million	299	50	3
		Small: assets < $700 million	2,224	50	13
	Credit unions	45 corporate credit unions	45	45	0
		Natural person credit unions, past users of MBS	1,147	54	2
		Natural person credit unions, no past usage, assets ≥ $50 million	1,204	25	0
		Natural person credit unions, no past usage, assets < $50 million	10,984	25	0
Total	**N/A**	**N/A**	**191,447**	**2,422**	**110**

Respondents	Nonrespondents	Follow-up sample	Follow-up ineligible	Follow-up respondents	Follow-up nonrespondents	Total responses	Response rate (percent)
71	42	19	7	12	0	83	78
59	14	7	4	2	1	61	88
55	19	7	1	5	1	60	82
30	10	6	2	3	1	33	87
33	14	10	2	6	2	39	87
27	10	5	0	3	2	30	81
38	7	3	1	2	0	40	91
50	2	0	0	0	0	50	96
25	0	0	0	0	0	25	100
22	3	0	0	0	0	22	88
1,554	**758**	**365**	**108**	**201**	**56**	**1,755**	**80**

Source: GAO.

Calculation of Survey Estimates

The overall survey statistics appearing in this report represent estimates of the entire population of U.S. private industry and state and local governmental entities from which the sample was drawn. To be able to make an estimate of the entire population, each questionnaire we received was statistically adjusted, or "weighted," so that its influence in determining the overall survey result was proportional to the number of other, nonsampled entities it had to represent in its industry. Specific weights were calculated for returned questionnaires within each of the substrata formed by the cross-classification of industry with organizational size and/or past usage. The weights were also adjusted to represent different sample selection rates within substrata for the initial sample and the follow-up sample of nonrespondents.

Not all of the sample substrata are included in the overall survey results. Five of the "smallest" substrata were removed from the overall survey estimates made in this report and analyzed separately. They were: small cities and counties, small special districts, small school districts, small private pension and union funds, and small nonuser credit unions. These five substrata represent populations that are very numerous, yet very low in financial assets and activity. We discovered a very low rate of product usage among these entities and, therefore, decided to separate them from the rest of the sample. See tables I.3 and tables I.5 through I.8 for the estimates of usage of the various products by these very small organizations. Although the size of the entire original population, including the 5 smallest strata, is approximately 191,000, the population to which we project our overall survey estimates in this report, after removing the very small organization strata and adjusting the population for ineligibles, is approximately 49,000 organizations.

In addition to the overall estimates that are projectable to the entire population of U.S. public and private industry from which the sample was drawn, this report contains some estimates for more specific industry groupings. Because the number of sampled organizations falling within any 1 of the 19 industries was usually too small to yield precise estimates for that individual industry, we aggregated responses from several comparable industries to form 9 industry groups (see table I.2). For example, we combined questionnaires received from mutual funds, money market funds, and commodity pools into one analytical group. Although the individual industries combined in a group generally exhibit the same characteristics on most survey items, a great deal of variation may exist in rates of usage and satisfaction among some of the combined industries.

This report also breaks down survey results by the size of organization and/or past usage of certain MBS and derivative products across the entire sample and within each industry group. As previously described, we separated the industries into as many as four substrata. The cutpoints separating these substrata of "larger" from "smaller" organizations in each of the 19 industries are somewhat arbitrary and are based on different measures across each industry. As a result, "larger" organizations in one industry are not necessarily similar to those in another industry.

Beyond the limited breakdowns of the survey results by broad categories of industry and size, it is not possible to make any estimates of acceptable precision. Because the survey sample was designed to make overall estimates across a large number of industries, an insufficient number of sampled institutions exists within the fine categories of industry, size, geographical location, or other subgroups. Some subgroup estimates that are made in this report are accompanied by a note to the reader that the small number of observations involved make calculation of sampling error unfeasible and heighten the likelihood of significant nonsampling error.

The concept of sampling errors and other survey errors is discussed in the following sections.

Sampling Error

Because we reviewed a statistical sample of organizations, each estimate developed from the sample has a measurable precision, or sampling error. The sampling error is the maximum amount by which the estimate obtained from a statistical sample can be expected to differ from the true population value we are estimating. Sampling errors are stated at a certain confidence level—in this case 95 percent. This means that the chances are 19 out of 20 that if we surveyed all of the organizations in the population, the true value obtained for a question on this survey would differ from the estimate obtained from our sample by less than the sampling error for that question. The sampling errors for all of the survey estimates made in this report are listed in tables I.3 through I.14. For the state treasury, GSE, and other financial institution strata, we selected all known organizations in the population as defined, so there is technically no sampling error associated with those estimates. However, missing observations due to the nonresponse of some of the sampled organizations in those strata creates statistical uncertainty similar to sampling error.

Nonsampling Errors

In addition to the reported sampling errors, the practical difficulties of conducting any survey may introduce other types of errors, commonly referred to as nonsampling errors. For example, intentional or accidental misreporting, differences in how a particular question is interpreted, the level of effort a respondent makes to answer the questions accurately, or the types of people who do not respond can introduce unwanted variability into the survey results.

We included steps in the questionnaire design, data collection, and data analysis stages for the purpose of reducing such nonsampling errors. While designing the questionnaire, we solicited expert opinions on the wording and structure of our questions and their answer categories, we received feedback on our questions and answers during a focus group with end-users, and we pretested the survey instrument with five organizations from our sample.

During data collection, we checked whether some answers respondents gave on their questionnaires were logically consistent with other answers. While conducting an in-depth telephone follow-up with a sample of respondents who were particularly satisfied or dissatisfied with sales practices, we attempted to verify some of their previous answers and thus gauge the reliability of a subset of the questions.

To reduce nonresponse bias, we attempted to convert a sample of 50 percent of the nonrespondents to respondents through telephone follow-ups. To assess the potential impact of nonresponse on our estimates, we examined a group of respondents who may be similar to nonrespondents in terms of characteristics that determine questionnaire responses—those organizations that were initially nonrespondents but were converted through telephone follow-up. When we compared the answers of those converted nonrespondents to organizations that responded without follow-up, we found the only material difference to be that a smaller proportion of the converted nonrespondents used MBS and fewer were dissatisfied with the sales practices of dealers offering MBS. Finally, in processing and tabulating the survey data, we employed a number of procedures to reduce errors that arise from these activities.

Sampling Errors Associated With the Key Survey Estimates Cited in This Report

Table I.3: Proportion of Organizations Using OTC Derivatives (Plain Vanilla or More Complex) in the 12 Months Preceding Receipt of Survey, by Size Category and Industry Group

Organizations, by size category and industry group	Estimate (percent)	Sampling error (±) (percent)
Size category:		
All organizations in the population, excluding the five smallest strata	11%	2%
Large organizations	14	2
Small organizations, excluding the five smallest strata	9	3
Smallest five strata (smallest local governmental entities, smallest credit unions, and smallest private pension funds)	<1	[a]
Industry group:		
Banks and thrifts, credit unions, and insurance companies	5	3
Endowments, foundations, and college and university operating funds	7	5
Other financial corporations (credit financing firms, mortgage brokers and lenders, and leasing agencies)	54	6
GSEs	71	3
Money managers	10	5
Mutual funds, money market funds, and commodity pools	27	9
Public and private pension funds and retirement systems	10	5
Publicly and privately held nonfinancial corporations	10	5
State and local governmental entities	4	[a]

[a]Number of cases insufficient to make an estimate.

Source: GAO.

Table I.4: Proportion of Estimated Total Users Represented by Each Industry Group

Industry group	Estimate (percent)	Sampling error (±) (percent)
Banks and thrifts, credit unions, and insurance companies	12%	7%
Endowments, foundations, and college and university operating funds	11	7
Other financial corporations	1	<1
GSEs	<1	<1
Money managers	3	2
Mutual funds, money market funds, and commodity pools	39	10
Public and private pension funds and retirement systems	9	5
Publicly and privately held nonfinancial corporations	22	10
State and local governmental entities	2	[a]
Total	**100%**	**N/A**

[a]Number of cases insufficient to make an estimate.

Source: GAO.

Table I.5: Proportion of Organizations Using Plain Vanilla OTC Derivatives, by Size Category and Industry Group

Organizations, by size category and industry group	Estimate (percent)	Sampling error (±) (percent)
Size category:		
All organizations in the population, excluding the five smallest strata	10%	2%
Large organizations	14	2
Small organizations, excluding the five smallest strata	9	3
Smallest five strata (smallest local governmental entities, smallest credit unions, and smallest private pension funds)	<1	[a]
Industry group:		
Banks and thrifts, credit unions, and insurance companies	5	3
Endowments, foundations, and college and university operating funds	6	5
Other financial corporations (credit financing firms, mortgage brokers and lenders, and leasing agencies)	54	6
GSEs	68	3
Money managers	10	5
Mutual funds, money market funds, and commodity pools	27	9
Public and private pension funds and retirement systems	10	5
Publicly and privately held nonfinancial corporations	10	5
State and local governmental entities	3	[a]
Other subgroups:		
Large publicly and privately held nonfinancial corporations	66	12
Large public pension funds and retirement systems	41	9
Proportion of organizations that have not used plain vanilla OTC derivatives, but have received a proposal to enter into such a contract in the last 12 months	8	2

[a]Number of cases insufficient to make an estimate.

Source: GAO.

Table I.6: Proportion of Organizations Using More Complex OTC Derivatives, by Size Category and Industry Group

Organizations, by size category and industry group	Estimate (percent)	Sampling error (±) (percent)
Size category:		
All organizations in the population, excluding the five smallest strata	2%	1%
Large organizations	4	1
Small organizations, excluding the five smallest strata	1	[a]
Smallest five strata (smallest local governmental entities, smallest credit unions, and smallest private pension funds)	0	0
Other subgroups:		
Proportion of organizations that have not used, but have received a proposal for more complex OTC derivatives	6	2

[a]Number of cases insufficient to make an estimate.

Source: GAO.

Table I.7: Proportion of Organizations Using MBS, by Size Category and Industry Group

Organizations, by size category and industry group	Estimate (percent)	Sampling error (±) (percent)
Size category:		
All organizations in the population, excluding the five smallest strata	24%	3%
Large organizations	37	4
Small organizations, excluding the five smallest strata	19	4
Smallest five strata (smallest local governmental entities, smallest credit unions, and smallest private pension funds)	3	[a]
Industry group:		
Banks and thrifts, credit unions, and insurance companies	55	8
Endowments, foundations, and college and university operating funds	16	7
Other financial corporations (credit financing firms, mortgage brokers and lenders, and leasing agencies)	23	4
GSEs	73	3
Money managers	33	8
Mutual funds, money market funds, and commodity pools	25	9
Public and private pension funds and retirement systems	24	7
Publicly and privately held nonfinancial corporations	2	[a]
State and local governmental entities	7	5
Other subgroups:		
Small banks and thrifts, credit unions, and insurance companies	40	11
All other organizations except for small banks and thrifts, credit unions, and insurance companies	21	2
Large public pension funds and retirement systems	74	9
Proportion of organizations that have not used MBS, but have received a proposal to enter into such a contract in the last 12 months	4	2

[a]Number of cases insufficient to make an estimate.

Source: GAO.

Table I.8: Proportion of Organizations Using Structured Notes, by Size Category and Industry Group

Organizations, by size category and industry group	Estimate (percent)	Sampling error (±) (percent)
Size category:		
All organizations in the population, excluding the five smallest strata	16%	3%
Large organizations	22	3
Small organizations, excluding the five smallest strata	13	4
Smallest five strata (smallest local governmental entities, smallest credit unions, and smallest private pension funds)	2	[a]
Industry group:		
Banks and thrifts, credit unions, and insurance companies	40	8
Endowments, foundations, and college and university operating funds	11	6
Other financial corporations (credit financing firms, mortgage brokers and lenders, and leasing agencies)	6	<1
GSEs	57	3
Money managers	20	7
Mutual funds, money market funds, and commodity pools	12	6
Public and private pension funds and retirement systems	5	4
Publicly and privately held nonfinancial corporations	3	[a]
State and local governmental entities	9	6
Other subgroups:		
Small banks and thrifts, credit unions, and insurance companies	35	13
All organizations except for small banks and thrifts, credit unions, and insurance companies	12	2
Large public pension funds and retirement systems	33	9
Proportion of organizations which have not used structured notes, but have received a proposal to enter into such a contract in the last 12 months	5	1

[a]Number of cases insufficient to make an estimate.

Source: GAO.

Table I.9: Proportion of Organizations Rating Overall Sales Practices for Dealers Used, by Product Offered

	Somewhat or very satisfied		Neither satisfied nor dissatisfied		Somewhat or very dissatisfied		No opinion	
Product	Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)
Plain vanilla OTC derivatives	85%	8%	13%	8%	2%	[a]	<1%	[a]
More complex OTC derivatives	79	19	[a]	[a]	[a]	[a]	[a]	[a]
MBS	71	8	20	8	7	4	2	[a]
Structured notes	64	11	20	9	13	9	4	[a]

[a]Number of cases insufficient to make an estimate.

Source: GAO.

Table I.10: Proportion of Organizations Rating Overall Sales Practices for Dealers Not Used, by Product Offered

	Somewhat or very satisfied		Neither satisfied nor dissatisfied		Somewhat or very dissatisfied		No opinion	
Product	Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)
Plain vanilla OTC derivatives	29%	9%	33%	9%	17%	7%	21%	10%
More complex OTC derivatives	16	9	51	14	26	12	7	[a]
MBS	20	8	46	10	27	8	8	7
Structured notes	15	7	48	12	29	10	8	[a]

[a]Number of cases insufficient to make an estimate.

Source: GAO.

Table I.11: Proportion of Organizations Somewhat or Very Dissatisfied With Disclosure of Downside Risks or Suitability of Products Proposed, by Dealers Used and Not Used

	Dealers used				Dealers not used			
	Disclosure of downside risks		Suitability of products proposed		Disclosure of downside risks		Suitability of products proposed	
Product	Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)
Plain vanilla OTC derivatives	6%	[a]	<1%	[a]	20%	8%	18%	7%
More complex OTC derivatives	12	[a]	3	[a]	38	13	42	13
MBS	5	3	4	3	27	8	36	9
Structured notes	17	9	7	[a]	31	10	39	10

[a]Number of cases insufficient to make an estimate.

Source: GAO.

Table I.12: Proportion of End-Users of a Product Who Believed a Fiduciary Relationship Exists

	Total of some and all cases	
Product	Estimate percent	Sampling error (±) (percent)
Plain vanilla OTC derivatives	53%	10%
More complex OTC derivatives	48	16
MBS	60	7
Structured notes	58	9

In all cases		In some cases		Never		No opinion	
Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)
35%	10%	18%	7%	31%	9%	16%	8%
28	15	19	10	36	16	16	15
37	7	23	6	25	6	15	6
36	9	22	7	26	9	16	6

Source: GAO.

Table I.13: Proportion of End-Users of a Product Who Believed a Fiduciary Relationship Exists in Some or All Cases, by Industry Group

	Plain vanilla OTC derivatives		MBS		Structured notes	
Industry group	Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)
Aggregated subgroup of large and small banks and thrifts, credit unions, and insurance companies	58%	24%	63%	10%	63%	13%
Endowments, foundations, and college and university operating funds	31	[a]	58	24	34	[a]
Other financial corporations (credit financing firms, mortgage brokers and lenders, leasing agencies)	54	6	75	4	73	[a]
GSEs	27	4	38	4	41	5
Money managers	39	24	52	15	49	20
Mutual funds, money market funds, and commodity pools	42	18	52	24	47	23
Public and private pension funds and retirement systems	78	[a]	51	20	69	[a]
Publicly and privately held nonfinancial corporations	73	19	63	[a]	86	[a]
State and local governmental entities	81	[a]	87	[a]	84	[a]

[a]Number of cases insufficient to make an estimate.

Source: GAO.

Table I.14: Proportion of All End-Users of a Product That Relied on the Dealer for Investment Advice

	To some, moderate, great, or very great extent	
Product	Estimate (percent)	Sampling error (±) (percent)
Plain vanilla OTC derivatives	59%	10%
More complex OTC derivatives	64	15
MBS	73	6
Structured notes	84	6

To a great or very great extent		To some or a moderate extent		To little or no extent		No opinion	
Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)	Estimate (percent)	Sampling error (±) (percent)
28%	10%	31%	9%	36%	10%	5%	3%
28	18	36	16	32	15	4	[a]
36	7	37	7	20	6	7	3
42	9	42	9	10	5	6	4

[a]Number of cases insufficient to make an estimate.

Source: GAO.

GAO Survey of Sales Practices for OTC Derivatives, Structured Notes, and Asset-Backed Securities

U.S. General Accounting Office

Survey of Sales Practices for OTC Derivatives, Structured Notes, and Asset-backed Securities

INSTRUCTIONS

GAO is surveying a wide range of public and private institutions in conjunction with its research on the sales practices of dealers of plain vanilla and more complex over-the-counter (OTC) derivative products, structured notes, and asset-backed securities.

Please continue with this questionnaire even if your organization does not use any such financial products, or if your organization employs external money managers or pools its funds. We would like every organization to answer a few short questions.

The most senior finance officer(s) in this organization (the organization specified in the cover letter) who is familiar with its policies, procedures, and practices regarding these products should complete the relevant sections of this questionnaire. Please do not forward it to any external money managers or investment pools.

Survey results will be reported in summary form only. Any discussion of individual answers will NOT identify the respondent. The number on this questionnaire is only to aid our follow-up efforts.

If you have any questions, please call Dave Diersen or Mel Thomas at (800) 333-4524.

Please return the completed questionnaire within 10 days of receipt to avoid costly follow-up efforts. If the preaddressed envelope is misplaced, please mail the questionnaire to:

U.S. General Accounting Office
Attn.: Dave Diersen
441 G St. NW, Room 3B28
Washington, D.C. 20548

BACKGROUND

A. Please indicate below the person in your organization we should contact to clarify answers to this questionnaire:

Name: ____________________

Title: ____________________

Organization: ____________________

Address: ____________________

____

Phone: ( ) ____________________

B. Approximately what percentage, if any, of your organization's investment funds are under the management of external money managers or held in investment pools? *(Enter "0" if none.)*

_____ % under external management

If any of your organization's funds are managed externally, please list the names of the principal managers or investment pools in the space below:

____

____

____

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____

Types of Financial Products Covered in this Questionnaire

We are interested in your experiences with four categories of financial products: **(1) plain vanilla OTC derivatives, (2) more complex OTC derivatives, (3) structured notes, and (4) asset-backed securities.** Each of these products will be defined and covered in the different sections of this questionnaire. Please read the definitions at the beginning of each section to determine which individual products to consider under each category when formulating your answers.

I. Plain Vanilla OTC Derivative Products

A derivative product is a financial instrument whose market value is derived from a reference rate, index, or value of an underlying asset. OTC derivatives are privately negotiated contracts and are not traded on organized exchanges.

Many OTC derivative products are available from a number of dealers and are readily priced. These **plain vanilla** products include such traditional instruments as fixed-interest rate for floating-interest rate swaps, purchased (long) options, interest rate forwards, and currency forwards.

Note: Do NOT include structured notes, such as inverse floating rate notes, or asset-backed securities, such as collateralized mortgage obligations (CMO). They will be covered in later sections.

1. Has your organization been a party to any **plain vanilla** derivative contracts at any time in the last 12 months?

   (Include any plain vanilla OTC derivative contracts your organization's funds were committed to, even if managed by an external manager or held in an investment pool.)

   1. ☐ Yes - within the last 12 months
   2. ☐ No - only prior to last 12 months ➜ SKIP TO QUESTION 4
   3. ☐ No - never held such a product ➜ SKIP TO QUESTION 6

2. What was the total notional/contract amount, if any, of the **plain vanilla** OTC derivatives your organization was a party to at the end of your last fiscal year?

   (If an exact figure is not available, provide your best estimate. Enter "0" if none. Please provide the date for which the figure is reported.)

   US $ ____________ As of: |____|____|____|
   mm dd yy

3. Please consider all of the dealers, regardless of size, including securities firms, banks, and insurance companies, with which your organization entered into any **plain vanilla** OTC derivative contracts in the last 12 months.

You need not include any contacts with dealers that your external money managers or managers of pooled investment funds may have had; consider only your own organization's direct experiences with dealers related to funds managed in-house.

☐ If your organization has NOT directly ENTERED into any **plain vanilla** OTC derivative contracts in the last 12 months, check here and skip to question 4.

Overall, how satisfied or dissatisfied are you with the following sales practices of the dealers with which your organization HAS ENTERED into **plain vanilla** OTC derivatives contracts in the last 12 months? Please consider only the sales practices of the dealers and not the ultimate gain or loss on the contracts. *(Check only one box in each row.)*

	Very Satisfied (1)	Somewhat Satisfied (2)	Neither Satisfied Nor Dissatisfied (3)	Somewhat Dissatisfied (4)	Very Dissatisfied (5)	Do Not Know/ No Opinion (6)
1. Disclosure of downside risks						
2. Quality of transaction documentation provided						
3. Suitability of products proposed						
4. Competitiveness of pricing and other fees						
5. Provision of accurate mark-to-market pricing information						
6. Assistance in unwinding transactions						
7. **Overall rating of sales practices**						

Please make any comments on your ratings in the space below, or on the last page:

4. Do you believe that a fiduciary relationship exists when an organization such as yours enters into a contract with a dealer for a **plain vanilla** OTC derivative? *(Check only one box.)*

1. ☐ Yes - in all cases
2. ☐ Yes - in some cases
3. ☐ No - in no cases

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4. ☐ Do not know/no opinion

5. To what extent does your organization rely on the dealer that sold you the **plain vanilla** OTC derivative to provide investment advice related to the sale? *(Check only one box.)*

1. ☐ To a very great extent
2. ☐ To a great extent
3. ☐ To a moderate extent
4. ☐ To some extent
5. ☐ To little or no extent

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6. ☐ Do not know/no opinion

6. Now, please consider any OTHER dealers that have proposed **plain vanilla** OTC derivative contracts directly to your organization in the last 12 months, but with which your organization did NOT enter into any such contracts.

☐ If your organization has received no such proposals in the last 12 months, check here and skip to section II.

Overall, how satisfied or dissatisfied are you with the following sales practices of the dealers that have offered your organization **plain vanilla** OTC derivatives contracts in the last 12 months that you did NOT enter into? *(Check only one box in each row.)*

	Very Satisfied (1)	Somewhat Satisfied (2)	Neither Satisfied Nor Dissatisfied (3)	Somewhat Dissatisfied (4)	Very Dissatisfied (5)	Do Not Know/ No Opinion (6)
1. Disclosure of downside risks						
2. Suitability of products proposed						
3. Competitiveness of pricing and other fees						
4. Overall rating of sales practices						

Please make any comments on your ratings in the space below, or on the last page:

____

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4

II. More Complex OTC Derivative Products

Other **more complex** OTC derivatives have at least one of the following characteristics:

a. Their prices tend to be difficult to obtain because they are often available from only a few dealers.

b. The payments required by the derivative contract are calculated on the basis of more than one interest rate, currency, asset, or other factor. For example, a swap whose floating rate payment is a function of an interest rate in one country and the exchange rate of another country.

c. The derivative contract has terms that are not determined until some future date. For example, an option whose strike price is determined at exercise rather than set in the contract at purchase, a forward contract that specifies a range of prices at which the assets will be exchanged rather than one price, or an index amortizing swap whose maturity depends upon future market developments.

d. The contract involves a term that acts as a multiplier or increases the leverage of the rate(s) used to compute payments. For example, a swap that pays a floating rate multiplied by a constant term.

e. The contract CAN entail potentially unlimited risk. For example, a written option.

Note: Do NOT include structured notes such as inverse floating rate notes, or asset-backed securities such as CMOs. They will be covered in later sections.

7. Has your organization been a party to any contracts involving these **more complex** derivatives at any time in the last 12 months?

(Include any of the more complex OTC derivative contracts your organization's funds were committed to, even if managed by an external manager or in an investment pool.)

1. ☐ Yes - within the last 12 months
2. ☐ No - only prior to the last 12 months ➜ SKIP TO QUESTION 10
3. ☐ No - never held such a product ➜ SKIP TO QUESTION 12

8. What was the total notional/contract amount, if any, of the **more complex** OTC derivatives your organization was a party to at the end of your last fiscal year?

(If an exact figure is not available, provide your best estimate. Enter "0" if none. Please provide the date for which the figure is reported.)

US $ ____________________ As of: |______|______|______|
mm dd yy

9. Please consider all of the dealers, regardless of size, including securities firms, banks, and insurance companies, with which your organization entered into any **more complex** OTC derivative contracts in the last 12 months. Include any complex OTC derivative dealers that also sell plain vanilla derivatives, even if they are included in your ratings in the previous section.

You need not include any contacts with dealers that your external money managers or managers of investment pools may have had; consider only your own organization's direct experiences with dealers related to funds managed in-house.

☐ If your organization has NOT directly ENTERED into any of the **more complex** OTC derivative contracts in the last 12 months, check here and skip to question 10.

Overall, how satisfied or dissatisfied are you with the following sales practices of the dealers with which your organization HAS ENTERED into **more complex** OTC derivatives contracts in the last 12 months? Please consider only the sales practices of the dealers and not the ultimate gain or loss on the contracts. *(Check only one box in each row.)*

	Very Satisfied (1)	Somewhat Satisfied (2)	Neither Satisfied Nor Dissatisfied (3)	Somewhat Dissatisfied (4)	Very Dissatisfied (5)	Do Not Know/ No Opinion (6)
1. Disclosure of downside risks						
2. Quality of transaction documentation provided						
3. Suitability of products proposed						
4. Competitiveness of pricing and other fees						
5. Provision of accurate mark-to-market pricing information						
6. Assistance in unwinding transactions						
7. **Overall rating of sales practices**						

Please make any comments on your ratings in the space below, or on the last page:

10. Do you believe that a fiduciary relationship exists when an organization such as yours enters into a contract with a dealer for a **more complex** OTC derivative? *(Check only one box.)*

1. ☐ Yes - in all cases
2. ☐ Yes - in some cases
3. ☐ No - in no cases

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4. ☐ Do not know/no opinion

11. To what extent does your organization rely on the dealer that sold you the **more complex** OTC derivative to provide investment advice related to the sale? *(Check only one box.)*

1. ☐ To a very great extent
2. ☐ To a great extent
3. ☐ To a moderate extent
4. ☐ To some extent
5. ☐ To little or no extent

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6. ☐ Do not know/no opinion

12. Now, please consider any OTHER dealers that have proposed **more complex** OTC derivative contracts directly to your organization in the last 12 months, but with which your organization did NOT enter into any such contracts.

☐ If your organization has received no such proposals in the last 12 months, check here and skip to section III.

Overall, how satisfied or dissatisfied are you with the following sales practices of the dealers that have offered your organization **more complex** OTC derivative contracts in the last 12 months that you did NOT enter into? *(Check only one box in each row.)*

	Very Satisfied (1)	Somewhat Satisfied (2)	Neither Satisfied Nor Dissatisfied (3)	Somewhat Dissatisfied (4)	Very Dissatisfied (5)	Do Not Know/ No Opinion (6)
1. Disclosure of downside risks						
2. Suitability of products proposed						
3. Competitiveness of pricing and other fees						
4. **Overall rating of sales practices**						

Please make any comments on your ratings in the space below, or on the last page:

III. Structured Notes

Structured notes are debt securities (other than asset-backed securities) whose cash-flow characteristics (coupon rate, redemption amount, or stated maturity) depend upon one or more indices and/or that have embedded forwards or options. They are issued by corporations and by government-sponsored enterprises such as the Federal National Mortgage Association and the Federal Home Loan Bank System.

13. Has your organization held any **structured notes** at any time within the last 12 months?

(Include any structured notes your organization's funds were committed to, even if managed by an external manager or in an investment pool.)

1. ☐ Yes -- within the last 12 months
2. ☐ No -- only prior to the last 12 months ➜ SKIP TO QUESTION 16
3. ☐ No -- never held such a product ➜ SKIP TO QUESTION 18

14. What was the total market value, if any, of the **structured notes** your organization held at the end of your last fiscal year?

(If an exact figure is not available, provide your best estimate. Enter "0" if none. Please provide the date for which the figure is reported.)

US $ ____________________ As of: |______|______|______|
mm dd yy

15. Please consider all of the dealers, regardless of size, including securities firms, banks, and insurance companies, from which your organization has purchased any **structured notes** in the last 12 months. Include any dealers that also sell other products, even if they are included in your ratings in previous sections.

You need not include any contacts with dealers that your external money managers or managers of investment pools may have had; consider only your own organization's direct experiences with dealers related to funds managed in-house.

☐ If your organization has NOT PURCHASED any **structured notes** in the last 12 months, check here and skip to question 16.

Overall, how satisfied or dissatisfied are you with the following sales practices of the dealers from which your organization HAS PURCHASED any **structured notes** in the last 12 months? Please consider only the sales practices of the dealers and not the ultimate gain or loss on the products. *(Check only one box in each row.)*

	Very Satisfied (1)	Somewhat Satisfied (2)	Neither Satisfied Nor Dissatisfied (3)	Somewhat Dissatisfied (4)	Very Dissatisfied (5)	Do Not Know/ No Opinion (6)
1. Disclosure of downside risks						
2. Quality of transaction documentation provided						
3. Suitability of products proposed						
4. Competitiveness of pricing and other fees						
5. Provision of accurate mark-to-market pricing information						
6. Assistance in unwinding transactions						
7. **Overall rating of sales practices**						

Please make any comments on your ratings in the space below, or on the last page:

16. Do you believe that a fiduciary relationship exists when an organization such as yours purchases a **structured note** from a dealer? *(Check only one box.)*

1. ☐ Yes - in all cases
2. ☐ Yes - in some cases
3. ☐ No - in no cases

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4. ☐ Do not know/no opinion

17. To what extent does your organization rely on the dealer that sold you the **structured note** to provide investment advice related to the sale? *(Check only one box.)*

1. ☐ To a very great extent
2. ☐ To a great extent
3. ☐ To a moderate extent
4. ☐ To some extent
5. ☐ To little or no extent

----

6. ☐ Do not know/no opinion

18. Now, please consider any OTHER dealers that have offered to sell your organization **structured notes** in the last 12 months, but from which you did NOT purchase any such notes.

☐ If your organization has received no such offers in the last 12 months, check here and skip to section IV.

Overall, how satisfied or dissatisfied are you with the following sales practices of the dealers that have offered your organization **structured notes** in the last 12 months, but with which you have done NO structured notes business? *(Check only one box in each row.)*

	Very Satisfied (1)	Somewhat Satisfied (2)	Neither Satisfied Nor Dissatisfied (3)	Somewhat Dissatisfied (4)	Very Dissatisfied (5)	Do Not Know/ No Opinion (6)
1. Disclosure of downside risks						
2. Suitability of products proposed						
3. Competitiveness of pricing and other fees						
4. Overall rating of sales practices						

Please make any comments on your ratings in the space below, or on the last page:

IV. Asset-Backed Securities

Asset-backed securities, the bulk of which are mortgage-backed securities, entitle their purchasers to receive a share of the cash flows from a pool of assets, such as principal and interest repayments from a pool of mortgages (such as CMOs) or credit card receivables.

19. Has your organization held any **asset-backed securities** at any time in the last 12 months?

(Include any asset-backed securities your organization's funds were committed to, even if managed by an external manager or in an investment pool.)

1. ☐ Yes -- within the last 12 months
2. ☐ No -- only prior to the last 12 months ➔ SKIP TO QUESTION 22
3. ☐ No -- never held such a product ➔ SKIP TO QUESTION 24

20. What was the total market value, if any, of the following types of **asset-backed securities** your organization held at the end of your last fiscal year?

(If exact figures are not available, provide your best estimate. Enter "0" if none. Please provide the date for which the figure is reported.)

As of: |_______|_______|_______|
mm dd yy

Market Value of Asset-Backed Securities	
1. High-risk mortgage-backed securities, which are characterized by more volatility than a benchmark mortgage pass-through security, and include stripped mortgage-backed securities, such as interest only (IO) and principal only (PO) securities, and the more volatile tranches of CMOs and real estate mortgage investment conduits (REMICs).	$
2. Other, lower risk mortgage-backed securities, such as benchmark mortgage pass-through securities.	
3. All nonmortgage asset-backed securities, such as those backed by credit card receivables and commercial loans.	
TOTAL	$

21. Please consider all of the dealers, regardless of size, including securities firms, banks, and insurance companies, from which your organization has purchased any **asset-backed securities** in the last 12 months. Include any dealers that also sell other products, even if they are included in your ratings in previous sections.

You need not include any contacts with dealers that your external money managers or managers of investment pools may have had; consider only your own organization's direct experiences with dealers related to funds managed in-house.

☐ If your organization has NOT PURCHASED any **asset-backed securities** in the last 12 months, check here and skip to question 22.

Overall, how satisfied or dissatisfied are you with the following sales practices of the dealers from which your organization HAS PURCHASED any **asset-backed securities** in the last 12 months. Please consider only the sales practices of the dealers and not the ultimate gain or loss on the products. *(Check only one box in each row.)*

	Very Satisfied (1)	Somewhat Satisfied (2)	Neither Satisfied Nor Dissatisfied (3)	Somewhat Dissatisfied (4)	Very Dissatisfied (5)	Do Not Know/ No Opinion (6)
1. Disclosure of downside risks						
2. Quality of transaction documentation provided						
3. Suitability of products proposed						
4. Competitiveness of pricing and other fees						
5. Provision of accurate mark-to-market pricing information						
6. Assistance in unwinding transactions						
7. Overall rating of sales practices						

Please make any comments on your ratings in the space below, or on the last page:

22. Do you believe that a fiduciary relationship exists when an organization such as yours purchases an **asset-backed security** from a dealer? *(Check only one box.)*

1. ☐ Yes - in all cases
2. ☐ Yes - in some cases
3. ☐ No - in no cases

----

4. ☐ Do not know/no opinion

23. To what extent does your organization rely on the dealer that sold you the **asset-backed security** to provide investment advice related to the sale? *(Check only one box.)*

1. ☐ To a very great extent
2. ☐ To a great extent
3. ☐ To a moderate extent
4. ☐ To some extent
5. ☐ To little or no extent

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6. ☐ Do not know/no opinion

24. Now, please consider any OTHER dealers that have offered to sell your organization **asset-backed securities** in the last 12 months, but from which you did NOT purchase any such securities.

☐ If your organization has received no such offers in the last 12 months, check here and skip to the last page.

Overall, how satisfied or dissatisfied are you with the following sales practices of the dealers that have offered your organization **asset-backed securities** in the last 12 months, but with which you have done NO asset-backed securities business? *(Check only one box in each row.)*

	Very Satisfied (1)	Somewhat Satisfied (2)	Neither Satisfied Nor Dissatisfied (3)	Somewhat Dissatisfied (4)	Very Dissatisfied (5)	Do Not Know/ No Opinion (6)
1. Disclosure of downside risks						
2. Suitability of products proposed						
3. Competitiveness of pricing and other fees						
4. **Overall rating of sales practices**						

Please make any comments on your ratings in the space below, or on the last page:

____

____

V. For all respondents, whether or not your organization uses derivatives:

25. If you have any additional explanations of the answers you have provided, or any comments concerning this questionnaire, please use the space provided below to add them. Attach additional sheets if necessary.

Thank you for your time and care in filling out this questionnaire.
Please return it in the envelope provided, or to the address listed on the first page.

2-95/CR/233441

Comments From the Board of Governors of the Federal Reserve System

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SUSAN M. PHILLIPS
MEMBER OF THE BOARD

July 30, 1997

Ms. Jean Gleason-Stromberg
Director, Financial Institutions and Markets Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Ms. Gleason-Stromberg:

Thank you for the opportunity to comment on your draft report to Congress concerning sales practices for over-the-counter (OTC) derivatives, mortgage-backed securities, and structured notes. We are pleased with your recognition that Federal Reserve examiners are thorough in addressing issues related to sales practices and that they address areas that may not be specifically listed in written exam procedures when they believe such reviews are relevant to evaluating the adequacy of a bank's activities. This illustrates the importance of examiner judgement in the supervisory process and speaks positively of the training and initiative of examiners in responding to emerging issues. At a time in which bank activities, financial products, and standards of sound practice have evolved rapidly, providing examiners the flexibility to exercise judgement has been particularly important. It is, however, also necessary to ensure that our supervisory policies and examiner guidance formally codify those elements of our current examinations that have been enhanced over the past several years in response to evolving market practices and our own experiences. As your report notes, that process is currently underway.

The Board has always sought to ensure that its examination of trading activities, including the sale of OTC derivatives, remains effective and that new issues are adequately addressed as they arise. The Federal Reserve initially addressed sales practices for these instruments in policy guidance in 1993 and subsequently expanded that guidance with the release of its Trading Activities Manual the following year. That manual, in turn, represented the first comprehensive, detailed discussion of regulatory procedures regarding the management and oversight of trading and derivatives activities and helped to clarify supervisory expectations in this area. Moreover, our supervisory action against Bankers Trust illustrates the importance we attach to advancing sound practices in this area.

Ms. Jean Gleason-Stromberg
Page Two

As your study points out, our guidance advises banks to establish standards regarding sales practices to ensure that counterparties are not entering into transactions in complex products where they do not understand the risks. Such standards are expected to keep pace with sound practices and appropriate emerging issues. Institutions are also expected to have adequate internal controls to assure adherence with these standards. Accordingly, as a general philosophy, our exam procedures emphasize evaluation of the adequacy of internal standards and explicitly instruct examiners to recommend corrective action when internal controls are found to be deficient in any area. In doing so, our exam procedures attempt to cover a broad range of issues that might be addressed in an institution's standards but, at the same time, encourage examiners to use their experience and judgement to address evolving industry practices, emerging issues, and other areas posing the greatest risk to the institution.

As you know, staff of the Board and the Federal Reserve Bank of New York are currently revising the Board's Trading Activities Manual, including those sections dealing with ethics and sales practices. While much of the guidance issued in 1993 and 1994 continues to represent sound banking practice, several areas of the manual are being revised to incorporate those elements of our current examinations that have been enhanced over the past several years in response to the evolution of market practices and our own experiences. Your draft report points out that our proposed revisions on ethics and sales practices adequately address the areas that GAO found were not specifically mentioned in prior guidance but that were, nevertheless, reviewed during targeted examinations. In response to your recommendation to Chairman Greenspan, we fully anticipate issuing this revised guidance by year-end 1997. Moreover, the process of revising our Trading Activities Manual is being substantively changed so that sections of the manual can be updated more easily as market practices, supervisory techniques, and examination procedures evolve. We believe the forthcoming enhancements and our on-going efforts should ensure that our review of the sales practices of institutions under the Board's supervision will remain appropriate and well targeted.

See comment.

The GAO draft report also calls for dealers and end-users to reach an agreement on the nature of their relationship in OTC derivatives transactions. The Federal Reserve has recognized the importance of and encouraged voluntary industry efforts in this area. We have every reason to expect that industry efforts will continue to evolve as both dealers and end-users benefit from their experience in the OTC derivatives market. An important step in this process is to ensure that both parties understand their risk management responsibilities regarding OTC derivative, mortgage-backed securities, and structured note transactions. Unfortunately, there is generally less guidance specifically designed for end-users than there is for traders and dealers. To this end, Federal Reserve guidance on the investment and end-user activities of banking institutions may be helpful to end-users generally.[1] This guidance

SR 95-17 "Evaluating the Risk Management and Internal Controls of Securities and Derivatives Contracts Used in Nontrading Activities" March 28, 1995: and, "Acquisition and Management of Nontrading Securities and Derivative Instruments" Commercial Bank Examination Manual, November 1995.

Ms. Jean Gleason-Stromberg
Page Three

discusses the importance of senior management oversight and a sound risk management process that identifies, measures, monitors, and controls the risks of an end-user's securities and OTC derivatives holdings. With respect to sales-practices, this guidance advises end-users that regardless of any responsibility, legal or otherwise, assumed by a dealer or counterparty, the acquiring institution is ultimately responsible for understanding and managing the risk of the transactions into which it enters. Additional guidance is offered on the need for clearly defined acquisition standards, new product reviews, measurement techniques, and monitoring systems.

In summary, we believe the GAO report makes a useful contribution to assessing the current state of financial market sales practices.

Sincerely,

Susan M. Phillips

The following is GAO's comment on the July 30, 1997, letter from the Board of Governors of the Federal Reserve System.

GAO Comment

The Federal Reserve commented that its guidance on the investment and end-user activities of banking institutions may be helpful to end-users generally. We agree and have added a specific citation to this guidance as well as Office of the Comptroller of the Currency guidance for institutions acting as end-users of OTC derivatives and other financial products.

Comments From the Office of the Comptroller of the Currency

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

July 31, 1997

Ms. Jean Gleason Stromberg
Director, Financial Institutions and Markets Issues
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Ms. Stromberg:

We have reviewed your draft audit report titled OTC Derivatives: Additional Oversight and Guidance Could Reduce the Potential for Costly Sales Practice Disputes. The audit was conducted at congressional request to determine the prevalence of disputes in the sale of over-the-counter (OTC) derivatives. Because market participants and others also expressed concerns about sales practices associated with mortgage-backed securities and structured notes, your review also included an evaluation of sales practices associated with these products.

Your review was comprehensive in evaluating sales practices from the perspectives of dealers, end-users and regulators. You found that federal sales practice requirements vary, that satisfaction with sales practices was high and disputes were limited though losses were often large, and that disagreement over counterparty responsibilities increases the potential for disputes. You also found that actions taken by dealers and end-users reduce the potential for disputes and that bank examinations are thorough.

We concur in your findings and have no substantive comments to offer. As noted in your report, the OCC's guidance addresses the key areas you identified in which dealer practices led to costly disputes with end users in the past.

Thank you for the opportunity to review and comment on the draft report.

Sincerely,

Laura L McAuliffe for

Judith A. Walter
Senior Deputy Comptroller for Administration

Comments From the Securities and Exchange Commission

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

August 15, 1997

Ms. Jean Gleason-Stromberg
Director, Financial Institutions
and Market Issues
General Government Division
General Accounting Office
Washington, DC 20548

Dear Ms. Gleason-Stromberg:

I appreciate the opportunity to comment on the General Accounting Office's ("GAO") draft report entitled <u>OTC Derivatives: Additional Oversight and Guidance Could Reduce the Potential for Costly Sales Practice Disputes</u> ("Draft Report"). I commend the GAO on its compilation of the data detailed in the Draft Report and believe it will contribute to the overall understanding of the over-the-counter ("OTC") derivatives market.

See p. 139.

I am concerned, however, that the Draft Report does not fully acknowledge the role of the Working Group in coordinating oversight of the OTC derivatives market. As you know, the Working Group, chaired by the Secretary of the Treasury, was established on the premise that interagency coordination and information-sharing is imperative in light of the growth of financial markets and the development of new instruments that cross traditional jurisdictional lines.

You recommend that the Working Group establish a mechanism for systematically monitoring developments in the OTC derivatives market to assess whether federal sales practice standards are warranted. The Working Group, however, is already actively monitoring these developments. Each individual agency has mechanisms in place to periodically collect pertinent information about the OTC derivatives market. They then regularly discuss this information with other members of the Working Group to determine whether individual or coordinated action is necessary. In addition to the regular meetings of the principals of the various agencies, a Steering Committee, chaired by the Treasury and comprising senior staff from these agencies, meets every two weeks.

Ms. Jean Gleason-Stromberg
August 15, 1997
Page 2

See p. 140.

You also recommend that the Working Group consider the extent to which it should assist end-users and dealers in reaching agreement on the nature of their relationships in transactions involving non-securities OTC derivatives. In its ongoing efforts to address prominent financial market issues, the Working Group has had discussions with end-users and professional counterparties. The Division believes the Working Group would be willing to continue this valuable dialogue. Nevertheless, we do not believe that it is necessary for the government to intervene and define contractual obligations for professional and sophisticated counterparties. In any case, the results of your Draft Report suggest that such interference is not warranted at this time; you note that most end-users are generally satisfied with the sales practices of their dealer counterparties.

See p. 142.

In addition, you recommend that the Commission and the CFTC establish a mechanism to determine whether the securities firms' affiliates are following the sales practice provisions of the Derivatives Policy Group's ("DPG") Framework for Voluntary Oversight ("Framework"). The non-registered affiliates that participate in the Framework currently provide the Commission with several reports in accordance with the standards developed in the Framework. The reporting affiliates send periodic reports to the Commission and the CFTC on credit and market risk exposure arising from non-securities OTC derivatives activities. The Commission and the CFTC also receive annual reports from external auditors regarding the affiliates' compliance with the risk management control objectives. The Division is willing to discuss with the reporting affiliates the feasibility of extending the external auditor's role to incorporate a review of sales practices procedures.

In addition to our comments on the recommendations, we have the following three general concerns with the Draft Report:[1/]

See comment 1.

First, the Draft Report discusses the similarities between the Framework, established by the DPG, and the Principles and Practices for Wholesale Financial Market Transactions ("Principles"), established under the coordination of the Federal Reserve Bank of New York. The Draft Report, however, fails to discuss the important differences between the Framework and the Principles. For instance, in the body of the Draft Report, you note that both the Framework and the Principles consider non-securities OTC derivatives transactions to be "arms-length";

1/ These comments are in addition to the technical comments the Division provided to the GAO in telephone conversations on June 10, 1997 and August 4, 1997.

Ms. Jean Gleason-Stromberg
August 15, 1997
Page 3

however, there is no further discussion of the affirmative responsibility, under the Framework, for a professional counterparty to clarify the nature of the relationship when it becomes aware that the nonprofessional counterparty mistakenly believes that the professional has assumed advisory obligations. Another distinction that is not discussed, but alluded to in the table at page 4-15, is that while the Principles recommend that policies regarding the use of financial products be maintained and compliance procedures enforced, the Framework goes further by expressly recommending that controls be established to reduce the risk of misunderstandings and contractual disputes with counterparties. In addition, the Principles may be implemented in whole or in part, whereas the DPG has indicated that the Framework should be implemented in its entirety.

Now on p. 90.

See comment 2.

Second, you state at page 4-13 that "the Framework applies only to the six firms and only to their nonsecurity OTC derivatives activities." While this statement is correct, it implies that there may be a large number of firms, as well as a large amount of activity, operating outside this Framework. As you know, the six unregistered affiliates of the major firms that follow the standards established by the Framework are responsible for more than 90% of the non-securities OTC derivatives business conducted by unregistered affiliates of broker-dealers. They do not, however, conduct transactions in OTC derivatives that are securities. Currently, all transactions involving securities derivatives must be conducted through a broker-dealer registered with, and regulated by, the Commission.

Now on p. 88.

See comment 3.

Third, the Draft Report blurs the distinction, both in the text and the charts, between OTC derivatives that are securities and OTC derivatives that are not. For example, the chart at page 4-11 distinguishes mortgage-backed securities ("MBS") and structured notes from OTC derivatives. The correct distinction would be between MBS, structured notes, and OTC derivatives that are securities, and non-securities OTC derivatives. Readers may be misled to conclude that sales practices in all OTC derivatives require reevaluation, even though the sales practices of registered broker-dealers involving securities derivatives are fully regulated by the Commission.

See comment 4.

Thank you again for this opportunity to provide comments to the GAO as it prepares its final draft of the report.

Sincerely,

Richard R. Lindsey
Director

The following are GAO's comments on the Securities and Exchange Commission's (SEC) August 15, 1997, letter.

GAO Comments

1. SEC commented that our draft report did not adequately discuss the differences between the two sets of dealer-issued guidance—the Framework for Voluntary Oversight and the Principles and Practices for Wholesale Financial Market Transactions. First, SEC stated that, while our draft report noted that both sets of guidance assert the relationship between parties to nonsecurities over-the-counter (OTC) derivatives transactions is one of arm's length, the report provides no additional discussion of the affirmative responsibility, under the Framework, for a dealer to clarify the nature of the relationship when it becomes aware that the nonprofessional counterparty (end-user) mistakenly believes that the dealer has assumed advisory obligations. Second, SEC stated that our draft report alluded in table 4.1, but did not discuss, that, while the Principles recommends that policies regarding the use of financial products be maintained, the Framework goes further by expressly recommending that controls be established to reduce the risk of misunderstandings and contractual disputes between parties.

Although differences between the two sets of dealer-issued guidance exist, we did not find these differences to be material, and we did not find them to exist in the two respects that SEC cited. Our overall analysis of the key provisions of each set of guidance indicates that they are consistent in the following: type of relationship they assert; the degree to which the parties should rely on each other; and the specific responsibilities of parties regarding the disclosure of risk, the exchange of pricing and valuation information, and the controls that should be in place. Also, given that adherence to each set of guidance is voluntary, the difference in terminology used is not material. This report now notes that a member of the Principles drafting committee, whose firm also served on the committee that developed the Framework, reached the same general conclusion. He stated that the spirit of the two documents is the same and that it would be unfair to contrast them simply because they use different language in some sections.

Regarding the first difference between the Framework and Principles that SEC cited, table 4.1 of this report provides our summary of the key sales practice provisions of these two sets of guidance. In this table, we state that the Framework indicates that professional intermediaries (dealers) should take steps to clarify the relationship if its counterparty appears to believe that the dealer has assumed an advisory role. However, this responsibility is not unique to the Framework, as the Principles, in section 5.2, similarly states that participants may wish to maintain policies and procedures for identifying and addressing exceptional situations that pose relationship, reputational, or litigation (compliance) risks, including those in which the counterparty appears to assume incorrectly that it may rely on the participant for recommendations or investment advice. This section of the Principles also represents the provision related to controls that SEC cited as a second difference between the two sets of dealer-issued guidance. The draft report summarized this aspect of both sets of guidance.

In addition, we added text in chapter 4 that cites a situation posing compliance and reputation risks for which both documents call for policies and procedures—that is, when counterparties incorrectly assume an advisory relationship exists. In summary, our report indicates that both sets of guidance contain similar expectations for participants regarding the need to establish controls to address the risk arising from misunderstandings and contractual disputes between parties.

2. In identifying another difference between the two sets of dealer-issued guidance, SEC stated that the Principles may be implemented in whole or in part, whereas the Framework should be implemented in its entirety. We found that this difference between the two sets of guidance results because the firms that have agreed to voluntarily adhere to the Framework have done so to avoid direct federal regulation. Notwithstanding this difference, our discussion of the key provisions of the two sets of guidance focuses primarily on the nature of the relationship and types of the responsibilities they advocate. Differences in the extent to which each set of voluntary guidance may be implemented is not material to this discussion; therefore, we did not modify the report.

3. SEC stated that while our draft report correctly indicated that the Framework applies only to six firms and only to their nonsecurities OTC derivatives activities, this implies that a large number of firms as well as a large amount of activity may be operating outside of the Framework. SEC stated that the six firms that have agreed to implement the Framework are responsible for more than 90 percent of the nonsecurities OTC derivatives business conducted by unregistered affiliates of broker-dealers, and that these affiliates do not conduct securities OTC derivatives activities, as these must be conducted through an SEC registered and regulated broker-dealer.

By describing the specific firms and activities covered by the Framework, we did not intend to imply that large amounts of securities firms' OTC derivatives activities are not addressed by the Framework or by some other regulatory regime. We acknowledged in the draft report that the participating firms account for 90 percent of the OTC derivatives activities of security firm affiliates. We revised this text to indicate that such activities involve nonsecurities OTC derivatives. Although we indicate in chapter 1 of this report that firms conducting securities activities must do so in affiliates registered with and subject to regulation by SEC, we have also added text to that effect in chapter 2.

4. SEC commented that our draft report did not always clearly distinguish between OTC derivatives that are securities and those that are not. We revised the text of this report and the figures appearing in chapters 3 and 4, as appropriate, to make this distinction. We also added text in chapter 2, explaining that OTC derivatives that are considered to be securities represent a small percentage of the overall volume of OTC derivatives.

Comments From the End-Users of Derivatives Association

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

End-Users of Derivatives Association, Inc.
P. O. Box 14467
Washington, D.C. 20044-4467
(202) 383-0639 FAX (202) 637-0229
E-MAIL: EUDA@aol.com

August 1, 1997

Ms. Jean Gleason-Stromberg
Director, Financial Institutions and Markets Issues
United States General Accounting Office
441 G Street, N.W.
Washington, DC 20548

Dear Ms. Gleason-Stromberg:

Thank you for providing the End-Users of Derivatives Association (EUDA) with the opportunity to comment on your draft report entitled OTC Derivatives: Additional Oversight and Guidance Could Reduce the Potential for Costly Sales Practice Disputes.

We support your proposed recommendations to have the President's Working Group establish a mechanism for systematically monitoring sales practices in OTC derivatives markets and assist market participants in better defining the relationship between end-users and dealers. Such steps would lead to greater market safety and soundness, particularly as it relates to new entrants whether they be dealers or end-users.

With regard to facilitating dialogue between end-users and dealers concerning the nature of their relationship in OTC transactions, your recommendation that the President's Working Group consider taking the initiative to bring the parties together is particularly welcome. Meaningful participation in such a dialogue on behalf of the end-user community has been one of EUDA's primary objectives over the past couple of years. As you know, EUDA has accepted an invitation to work with the Federal Reserve Bank of New York in updating the Principles and Practices for Wholesale Financial Market Transactions, which seek to define the dealer/end-user relationship. We have been advised that the meeting, initially scheduled for May 8, 1997, is in the process of being rescheduled. At this point we are optimistic that this meeting will help to pave the way for resolving our differences and reexamining portions of the Principles and Practices that EUDA found particularly objectionable.

With regard to EUDA references in your report, they are appropriately stated and accurately reflect EUDA's positions and actions over the past several years. Your report also correctly concludes that several issues related to sales practices and the relationship between dealers and end-users are unresolved.

End-Users of Derivatives Association, Inc.

Ms. Jean Gleason-Stromberg
August 1, 1997
Page 2

See comment.

As a general observation, the draft report seems to place considerable emphasis on the fact that where there have been disputes between dealers and end-users regarding sales practices, the financial losses involved have generally been large. While this may be true, at least for those disputes that have been publicly aired, it may cause some readers to believe that disputes over sales practices are largely the result of financial losses suffered by end-users. This would be unfortunate because it does not reflect the fact that other end-users have suffered large derivatives losses without raising any objection to dealer conduct. These losses were incurred in connection with derivative transactions that were to hedge a variety of financial and other risks inherent in the end-users' businesses and investment portfolios. These losses in large part were not unexpected in the sense that the derivatives operated as anticipated and were offset by gains in the underlying hedged items. Furthermore, these losses did not result in any dispute with the dealer counterparty. On the other hand, when derivatives operate in a fashion that is contrary to the end-user's expectations under particular market conditions and/or the manner in which the dealer has represented them to operate, disputes have arisen.

See p. 74.

In summary, it is our view that end-users by and large accept the risk of financial loss associated with derivative commitments and have in fact experienced such losses without dispute. At the same time, it is our view that there have been more disputes between end-users and dealers regarding sales practices than may have been aired publicly, many of which probably involved only modest losses. It is neither possible nor desirable to prevent end-users from realizing financial losses from derivatives transactions; it is entirely possible and desirable to reduce the number of disputes that arise between end-users and dealers with respect to derivatives sales practices.

Again, thank you for the opportunity to comment on your report. Please let us know if we can be of further assistance.

Sincerely,

William P. Miller II

William P. Miller II, CFA
Chairman

c: EUDA Board Members
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End-Users of Derivatives Association, Inc.

The following is GAO's comment on the End-Users of Derivatives Association's August 1, 1997, letter.

GAO Comment

The association commented that the draft report might give the impression that sales practice disputes are largely the result of end-users suffering large financial losses. It elaborated that end-users have suffered large losses without objecting to dealer conduct when derivatives that were used as hedges operated as dealers represented. In such cases, derivatives losses were offset by gains in the underlying hedged items.

We did not intend to imply that end-users routinely blame dealers when they incur losses. In chapter 3, we presented estimates of the percentage of reported losses in which sales practice concerns were raised. While we could not determine if the products were used for hedging, the data (which are not statistically valid) show that about 59 percent of publicized over-the-counter derivatives losses did not result in sales practice disputes. Nonetheless, we revised the report to further clarify that end-users do not routinely raise sales practice concerns when they incur losses and to describe the circumstances under which they might raise such concerns.

Comments From the Government Finance Officers Association

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

GOVERNMENT FINANCE
OFFICERS ASSOCIATION
1750 K Street, N.W., Suite 650, Washington, DC 20006
202/429-2750 • Fax: 202/429-2755

July 30, 1997

Jean Gleason Stromberg
Director, Financial Institutions
and Markets Issues
General Government Division
U.S. General Accounting Office
Washington, DC 20548

Re: GAO Draft Report
OTC DERIVATIVES: Additional Oversight and Guidance Could Reduce the Potential for Costly Sales Practice Disputes

Dear Ms. Stromberg:

Thank you for the opportunity to comment on the General Accounting Office's (GAO) draft report on OTC derivatives. The draft report follows GAO's usual practice of outlining the issue to be examined and using clearly defined terms throughout the discussion. It will be an extremely helpful reference on derivatives. The Government Finance Officers Association (GFOA) is pleased to provide the following comments, which highlight a few key areas of the draft report that we believe should be clarified to make this report even more useful to Congress and to market participants.

EXECUTIVE SUMMARY

Federal Sales Practice Requirements Vary

While this section of the draft report primarily refers to federal sales practice requirements, it alludes to the presence or lack of some state regulation of various types of derivative instruments. It is important to note that state securities regulators currently share responsibility for regulation and enforcement of some securities, and if OTC derivatives are securities, states may have some oversight responsibility for sales practices connected with them. GFOA believes that the GAO should recognize the role and the importance of state securities regulators in the current enforcement system, as it is intended to complement the federal system but has been under legislative and regulatory attack in recent years.

See comment 1.

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HEADQUARTERS OFFICE
180 North Michigan Avenue, Suite 800, Chicago, Illinois 60601
312/977-9700 • Fax: 312/977-4806

Disagreement Over Counterparty Responsibilities Increases the Potential for Disputes

See p. 100.

The draft report sets out the differences in understanding that dealers and end-users have regarding dealers' fiduciary responsibilities to their customers. This section outlines what end-users as well as GAO have been told about the assumption of specific investment adviser or fiduciary responsibilities by dealers if such relationships were agreed to in writing. While dealers maintain that this stance is driven by liability concerns, it is also constructive to note here that end-users have also been told that compensation concerns are a factor as well. Thus, according to some dealer representatives, end-users should reasonably expect a fiduciary duty from a dealer only when there has been additional compensation paid for specific services provided. Despite a pattern of providing what might otherwise be reasonably considered such services, dealers sometimes use payment provisions as an indication of whether or not a fiduciary relationship exists.

Changes in Market Characteristics Could Affect the Current Regulatory Approach

See p. 102.

Although much of the draft report focuses on the need for dealers, end-users and regulators to reach a meeting of the minds regarding counterparty responsibilities in OTC derivatives transactions, it is important to understand that, in the meantime, the courts are making these decisions for them. Thus, while legal costs may be a primary reason for the costly sales practice disputes discussed in the draft report, market participants should also realize, as the GAO points out, that their failure to come to terms has implications for the rights and responsibilities of the parties beyond the financial considerations.

FEDERAL SALES PRACTICE REQUIREMENTS VARY BY PRODUCT AND DEALER

Common Law-Based Claims Must Be Asserted in Disputes Involving OTC Derivatives That Are Not Subject to Federal Laws

While the ultra vires issue has been raised as a concern recently in disputes between governmental entities and dealers, it is not clear, as the footnote indicates, that this claim would only be raised by governmental entities. Certainly there are corporate investment activities that could occur beyond the scope of a company's charter or beyond the authority granted to perform certain investment activities by an agent or employee of a company. That this defense may not be common among corporate investors nevertheless does not mean it cannot be relied upon.

Bank Activities Are Regulated to Protect Their Financial Condition

In its discussion regarding determination of the suitability of OTC derivatives transactions for customers, the GAO reports that regulators believe such a rule would change the nature of their relationship between banks and their customers given the nature of certain other types of transactions. In the following section, the draft report discusses the new financial institution Suitability Interpretation, effective July 1, 1997, regarding sales practices for securities transactions.

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GFOA believes that this Suitability Interpretation, when applied to OTC derivatives that are securities, demonstrates that bank regulators have properly already embraced the concept of functional regulation -- that is, where banks are performing the same functions as securities firms, the sales practice rules under which they operate ought to be the same. In this case, the financial institution Suitability Interpretation mirrors that of the National Association of Securities Dealers.

See p. 52.

Thus, while financial institution regulators continue to emphasize the safety and soundness of the institution, there are nevertheless important areas in which investor protection will be equally important, and the legal and regulatory systems will support these protections.

SATISFACTION WITH SALES PRACTICES WAS HIGH AND DISPUTES WERE LIMITED, BUT WHEN DISPUTES OCCURRED LOSSES WERE OFTEN LARGE

Product Usage Varied by Industry

The GAO survey analysis breaks down usage of OTC derivatives, mortgage-backed securities and structured notes by financially oriented organizations and other, nonfinancial organizations. This designation, particularly the handling of public pension funds and state and local governments, may be misleading. Pension funds (both public and private) are included in the financially oriented category, while state and local governments are included among other organizations. The accurate categorization of public pension funds is therefore problematic.

See comment 2.

The discussion would benefit from some explanation regarding what the distinction between the two categories is and why there is a difference between public pension funds and other public funds. For example, the discussion refers to "local government entities" and their use of these products. However, there is no explanation of which local government funds are being referred to. The accompanying chart (Figure 3.4) would also be improved by such a clarification.

DISAGREEMENT OVER COUNTERPARTY RESPONSIBILITIES INCREASES THE POTENTIAL FOR DISPUTES

Dealer-issued Guidance Asserts an Arm's-Length Relationship

The draft report's treatment of both the Framework for Voluntary Oversight (Framework) and the Principles and Practices for Wholesale Financial Market Transactions (Principles) is extensive and thorough. There are a few additional points that should be made regarding these pieces of guidance.

See p. 142.

First, although both voluntary documents state that they are not intended to create legally enforceable obligations, the concern of end-users is that, if such guidance becomes customary and standard practice throughout the derivatives industry, these documents may in fact take on some legal authority. In addition, we now know that court documents filed by Bankers Trust Company made

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reference to the Principles and cited them for support of Bankers Trust's practices, despite the fact that the actions engaged in by Bankers Trust preceded the issuance of the Principles. Thus, not only was the defendant asking the court to rely on the Principles, it was asking the court to rely on them retroactively. This action has already borne out the fears of end-users regarding the seriousness of the voluntary guidance.

See comment 3.

Second, differences between securities laws and dealer-issued guidance are not limited to the types of entities to which each apply but to the process used to arrive at a final document or requirement. The draft report errs in its description of the participants in the transactions covered by the dealer-issued guidance. Participants, including end-users, contrary to the definitions included in the Principles, are not only "large financial and commercial entities...more likely to be financially sophisticated," as the draft report states. While this is certainly true in many cases, the counterparties included in the dealer-issued guidance fit this description, they also include state and local governments, churches, schools, charities, and others who, while they may have large portfolios, would not be construed as commercial entities or necessarily financially sophisticated. We caution the GAO in accepting the definition provided by the dealer documents, and urge it to make clearer the distinction between the Principles and GAO's analysis of them.

More important is the process by which the Principles and securities laws are arrived at. The Principles were organized and guided by the Federal Reserve Bank of New York and a small group of dealer representatives. The drafting of the document was done without input from a broad array of market participants, who were not aware of the ongoing effort nor included in the discussions or the drafting of the Principles. Only when the final version had been completed were end-users brought into the process. Likewise, the Framework meetings, led by the SEC and CFTC, in conjunction with dealer representatives, did not include any other market participants.

By contrast, laws are normally enacted only after hearings have been held, legislation has been released for public view and comment, and interested parties have had their say. Even the regulatory process requires the publication of proposed rules, a comment period, and further discussion prior to adoption of a rule. The differences in process between the dealer-issued guidance and securities laws could not be greater.

See comment 4.

In addition, while the draft report is technically correct in stating that the U.S. securities laws apply "generally" equally to all investors, they do in fact distinguish in certain instances between institutional and individual customers. For example, the NASD Conduct Rules require offerings to the public to comply with certain sales practice requirements. However, the Suitability Interpretation under the Conduct Rules, which was approved by the Securities and Exchange Commission in August 1996, effectively sets different standards for retail investors and institutional investors regarding the type of information needed prior to making an investment recommendation and how that information is to be obtained. Generally, there is a heightened standard for recommendations made to individual investors compared to those made to institutional investors,

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although the Interpretation states that a suitability obligation is owed to all investors. There are a number of other areas throughout the securities laws where distinctions are made on the basis of portfolio or type of entity involved in specific securities transactions.

See comment 5.

Third, with regard to comments submitted by state and local government organizations, including GFOA, on the Principles, it should be clarified that our concern regarding permissible reliance on dealer advice only when there was written acknowledgment by the dealer did not in this case represent our analysis of the Principles but was drawn directly from the document itself.

See comment 6.

In that same vein, we note that comments provided by an International Swaps and Derivatives Association board member regarding the use of dealer-issued guidance as a means of clarifying that dealers, "unless otherwise agreed to," do not have a fiduciary obligation in OTC derivatives transactions, is not settled law but represents only that individual's or organization's (this is unclear) opinion.

PROFESSIONAL ASSOCIATIONS ISSUED GUIDANCE FOR END-USERS

See p. 116.

The draft report correctly characterizes the recommended practice adopted by GFOA in June 1994 concerning the use of derivatives. However, other recommended practices adopted by the Association since that time are also relevant. Of particular significance are the following: Sale of Derivative Instruments by State and Local Governments (1995), which deals with the issuance and sale of municipal derivative instruments, and Diversification of Investments in a Portfolio (1997), which does not directly deal with derivatives but concerns portfolio risk factors. Copies of these recommended practices are attached to these comments.

SOME STATE GOVERNMENTS ACTED TO REDUCE THE RISK OF LOSS

See comment 7.

There is at least one additional state known to GFOA to have implemented via the executive branch a change in investment practices between 1994 and 1996. The State of Connecticut has instituted a range of controls in its investment policy regarding its relationship with dealers as well as types of permissible investment instruments. One important change is the requirement that the state treasurer, who has responsibility for the state local government investment pool (LGIP), must follow the "prudent expert" standard. This is a higher standard than that required of the prudent person/investor, based on the view that those administering funds entrusted to them must operate with the care, skill and diligence required of other like enterprises.

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See comment 8.

RECOMMENDATIONS

GFOA generally endorses the recommendations made by GAO in the draft report. However, we would extend those made to the Federal Reserve and the SEC and CFTC. Given the role that the Federal Reserve has played in guiding the participation and drafting of the Principles, GFOA urges the GAO to recommend to the Federal Reserve that it be more inclusive when it coordinates the issuance of dealer-issued guidance in any form outside the federal regulatory process. While we understand that the Principles represent a work in progress, end-users have not participated in any additional discussions or meetings with the drafters since it was originally issued.

We would ask the GAO to make a similar recommendation to the SEC and the CFTC with regard to the Framework. Surely the participation of federal regulators calls for a more open and inclusive process involving affected market participants than that which has occurred with regard to the Framework.

We hope these comments will be useful in developing the final report on OTC derivatives, and thank you again for the opportunity to comment.

Sincerely,

Betsy Dotson

Betsy Dotson
Assistant Director/Legislative Counsel
Federal Liaison Center

6

GFOA Recommended Practice

Diversification of Investments in a Portfolio (1997)

Background. State and local governments are charged with observing the investment management objectives of safety, liquidity, and yield. Portfolio risk includes all the risks associated with investments, such as credit risk and market risk. Risks to safety and liquidity can be mitigated through diversifying the types and maturities of securities purchased. Because ensuring safety and liquidity are paramount, entities should seek to reduce portfolio risk as much as possible in their investment policies through appropriate diversification of investments in the portfolio and restrictions on maturity provisions.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local governments diversify their investments to reduce portfolio risk through such means as

- limiting investments to avoid overconcentration in securities from a specific issuer or business sector, excluding U.S. Treasury securities;
- limiting investments in securities that have higher credit risks;
- investing in securities of varying maturities; and
- continuously investing a portion of the portfolio in readily available funds, such as local government investment pools (LGIPs), money market funds, or overnight repurchase agreements to ensure that appropriate liquidity is maintained to meet ongoing obligations.

References

- GFOA Sample Investment Policy, 1996.
- *Investing Public Funds*, Girard Miller, GFOA, 1986.

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GFOA Recommended Practice

Sale of Derivative Instruments by State and Local Governments (1995)

Background. State and local governments may use a wide range of financial derivative products to more effectively manage their debt portfolios. A derivative is a financial instrument created from or whose value depends on (is derived from) the value of one or more separate assets or indexes of asset values. Derivative products issued by state and local governments may include floaters/inverse floaters, collateralized mortgage obligations (CMOs), forwards, futures, and options. Derivative products may be a useful debt management tool if used prudently. These instruments may reduce the cost of borrowing or limit exposure to certain types of risk.

Recommendation. The Government Finance Officers Association (GFOA) encourages state and local officials to exercise extreme caution in the issuance and sale of derivative instruments and to consider their utilization only when they have developed a sufficient understanding of the products and the expertise for their appropriate use.

Governmental issuers of derivative products need to fully understand the risks associated with particular derivative instruments. Many of these products do not have large markets, which can make it difficult for governmental issuers to determine a fair market price. In addition, issuers need to be concerned that

- the use of these products may create uncertainty with respect to the issuer's future debt service obligation;
- the use of these products may have an undesirable effect on the issuer's credit quality;
- the issuer may be exposed to counterparty risk -- that is, the risk that the counterparty in the transaction may be unwilling or unable to meet its obligations; and
- once issued, these instruments may be difficult and costly to terminate.

To the extent possible, issuers should take actions to limit their risk exposure. This includes using appropriate hedging strategies to reduce exposure to debt service uncertainty, selecting counterparties of high credit quality, and developing contingency plans in the event that the use of the instrument must be terminated prematurely.

Governmental issuers of derivative products also should be mindful that these instruments may not be suitable for all investors due to certain inherent attributes of these products that can include

- high price volatility,
- illiquid markets,
- products that are not market-tested,
- highly leveraged products,
- products requiring a high degree of sophistication to manage effectively, and

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- products that are difficult to value.

If governmental issuers decide to issue derivative products, they should take steps to ensure that there is full and complete disclosure in the official statement. Full disclosure should include a clear summary of the special risks involved so that investors can make an informed decision about the appropriateness of the product for their portfolios. In particular, investors need to be informed about the issuer's legal authority to issue the securities, and their potential exposure to interest rate volatility and unusually large and rapid changes in market value. The issuer also may want to take other actions, such as conveying to the underwriting syndicate the issuer's expectations concerning marketing and monitoring of the types of investors to whom the instruments are being sold in the initial offering.

References

- "An Issuer's Perspective on Interest Rate Swaps," *Government Finance Review*, October 1992.
- "An Introduction to Municipal Derivative Products," *Government Finance Review*, February 1993.
- "An Introduction to Municipal Derivative Products: Part II," *Government Finance Review*, April 1993.
- GFOA Recommended Practice -- Use of Derivatives by State and Local Governments, 1994.

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The following are GAO's comments on the Government Finance Officers Association's July 30, 1997, letter.

GAO Comments

1. The association commented that we should recognize the role and importance of state securities regulators in enforcing the securities laws. We added a footnote to the executive summary and to chapter 1 to clarify that state agencies also oversee banking and securities activities but that this report does not assess their oversight in detail.

2. The association commented that the presentation in the draft report of survey statistics by financially oriented organizations and other nonfinancial organizations could be misleading. The association was particularly concerned about the treatment of public pension funds and state and local governments because pension funds (both public and private) were included in the financially oriented category, while state and local governments were included among other organizations. We clarified this report by adding footnotes to the related text that explain the types of organizations within each grouping. We also added a note to figure 3.4, indicating that appendix I describes the organizations included in the groupings.

3. The association commented that our draft report erred in relying on the Principles and Practices for Wholesale Financial Market Transactions when describing the participants in transactions covered by the dealer-issued guidance. The association elaborated that participants, including end-users, are not only large financial and commercial entities that are more likely to be financially sophisticated, but they also include state and local governments, churches, schools, charities, and others who, although holding large portfolios, would not be construed as commercial entities or would not necessarily be financially sophisticated.

The association correctly points out that participants may include end-users that are not large or financially sophisticated. However, our point was that the dealer-issued guidance was designed to apply to larger entities that tend to be financially sophisticated. In addition, our discussions with regulators and dealers as well as the results of our survey confirmed that the predominant users of over-the-counter (OTC) derivatives, mortgage-backed securities, and structured notes are larger organizations, most of which are in financially oriented industries and most of which tend to be more financially sophisticated.

4. The association commented that the draft report is technically correct in stating that the U.S. securities laws “generally” apply equally to all investors, but noted that these laws sometimes distinguish between institutional and individual customers. We added a footnote to chapter 4 that recognizes the securities laws and regulatory guidance that make distinctions between institutional and individual customers and modified the text to clarify that the antifraud provisions of U.S. securities laws do not make such distinctions.

5. The association commented that our report should clarify that the association’s concern regarding the ability of an end-user to rely on dealer statements only when acknowledged in writing by the dealer was not based on the association’s analysis of the Principles but was drawn directly from the document itself. Our draft report quoted from the letter the association sent to the Principles drafting committee, and that letter correctly interprets the Principles as requiring written agreement between the parties before one can rely on the other.

6. The association commented that the individual cited in the draft report as asserting that dealers, unless otherwise agreed to, do not have fiduciary obligations in OTC derivatives transactions was expressing his opinion or that of his employer. (We referred to this individual as the managing director of a large securities firm and the association referred to him as an International Swaps and Derivatives Association board member.) The association stated that this assertion has not been settled by law. We attributed the statement in question to the official who made it, and by doing so, indicated that it represents his opinion.

7. The association noted that an executive branch action in Connecticut was taken between 1994 and 1996 to institute changes to investment policies and controls in that state. We revised chapter 5 of this report to incorporate Connecticut’s action. We also added a footnote in chapter 5 to clarify that we did not attempt to obtain comparable information on all state actions to improve investment policies, procedures, and practices.

8. Although generally endorsing the recommendations in our report, the association asked that we recommend that the Federal Reserve, the Securities and Exchange Commission, and the Commodity Futures Trading Commission ensure that the process for coordinating the issuance of dealer-issued guidance in any form outside of the federal regulatory process be more inclusive of affected market participants. As the draft report indicated in chapter 7, we envisioned that the President’s Working

Group on Financial Markets might facilitate a process under which market participants could reach agreement on the nature of their relationship, including their responsibilities in transactions involving OTC derivatives. Implicit in our related recommendation is that a common set of mutually agreed-upon guidance would be issued for dealers and end-users. We make our recommendation to the Working Group, whose membership includes the Federal Reserve, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, in the belief that a coordinated effort by the federal market regulators would be more effective than individual efforts in addressing the need for end-users and dealers to reach agreement on the nature of counterparty relationships.

Comments From the International Swaps and Derivatives Association

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

ISDA
International Swaps and Derivatives Association, Inc.
600 Fifth Avenue, 27th Floor
Rockefeller Center
New York, NY 10020-2302
Telephone: (212) 332-1200
Facsimile: (212) 332-1212
e-mail: isda@isda.org
website: http://www.isda.org

One New Change
London EC4M 9QQ
Telephone: 0171-330-3550
Facsimile: 0171-330-3555
website: http://www.isda.org

August 15, 1997

Ms. Jean Gleason-Stromberg
Director, Financial Institutions and
Market Issues
United States General Accounting Office
General Government Division
Washington, D.C. 20548

Dear Ms. Gleason-Stromberg:

The International Swaps and Derivatives Association (ISDA) appreciates the opportunity to comment on the General Accounting Office's (GAO) draft report "OTC Derivatives: Additional Oversight and Guidance Could Reduce the Potential for Costly Sales Practice Disputes" (the GAO Report). As you may be aware, ISDA devoted a great deal of time and expertise when the GAO designed and administered the questionnaire it used for the 1995 survey, and continued to answer queries as the GAO analyzed the results of the survey. Our willingness to participate in this process reflects our continuing interest and involvement in the areas addressed in the report.

ISDA is an international financial trade association whose members comprise 318 of the world's largest commercial, merchant and investment banks and other institutions that act as dealers and end-users of swaps and other privately negotiated derivatives transactions. A list of the current membership and the ISDA Board of directors is included in Exhibit 1.

Introduction

ISDA appreciates the extensive work the GAO has completed with the design, administration and analysis of its questionnaire and follow-up surveys. We were confident and pleased that the survey results reinforced ISDA's view that counterparty relationships among participants in privately negotiated derivatives are robust and well-managed.

ISDA agrees with the GAO that the results of the survey are reassuring and do not imply the need for specific legislation or regulation. Since the members of the President's Working Group on Financial Markets are involved already in the consideration of developments in privately negotiated derivatives activity, it is not readily apparent that a formal monitoring mechanism would be any more effective than the existing structure. However, ISDA is confident that the President's Working Group will continue to be an important forum for the discussion of developments, and we will continue to maintain a dialogue with the members of the Working Group.

See p. 139.

We also agree with the GAO's qualification of its recommendation to involve the President's Working Group in assisting end-users and dealers in reaching agreement on the nature of their relationship. As the GAO states, "... the issues surrounding their relationships are complex and federal involvement may not necessarily result in an agreement that is widely accepted." In addition, there is no empirical evidence offered suggesting that the occurrence of disputes among privately negotiated derivatives participants is more frequent or egregious than in other areas of commercial dealings. In fact, the results of the GAO research suggest just the opposite. The voluntary actions taken by participants already stress that professional participants should avoid conduct which would mislead a counterparty as to the arm's length nature of the relationship. Privately negotiated derivatives activity has been extraordinarily free of abuses, by the GAO's own account, and regulators and the courts have had little difficulty so far in finding remedies where necessary. Therefore, there is no need for the President's Working Group to involve itself.

See p. 140.

Summary

In reviewing the GAO Report, we have found that the results of the GAO survey and its analysis of legal claims support the ISDA position that participants in privately negotiated derivatives transactions are making informed decisions with satisfactory outcomes. The evidence provided by the GAO clearly demonstrates that counterparties understand and accept the responsibilities and obligations of participating in wholesale financial market transactions. In addition, the clarity of this understanding and the general quality of counterparty interactions have minimized the legal claims of participants arising from dissatisfaction with the nature of the relationship. Given the GAO's own conclusion that, "most end users ... were generally satisfied with the sales practices of dealers with whom they did business" and that "...federal financial market regulators found that few dealers in these contracts were involved in sales practice disputes," ISDA does not support the GAO's recommendations for expanded activity by regulators.

See p. 141.

The GAO's policy recommendations do not follow logically from the facts or conclusions in the report, and contradict the strongly-held views of those directly involved in privately negotiated derivatives activity as participants or as regulators. As the GAO itself found when addressing specifically developments in privately negotiated derivatives, "...regulators and **market participants** (emphasis added)...have issued guidance on recommended practices and controls; strengthened sales practice or investment policies, procedures, and practices; and increased internal review of these activities." We believe that the GAO should have concluded, based on the facts and analysis in the report, that privately negotiated derivatives transactions exemplify an efficient market where participants continue to voluntarily refine and clarify the nature of counterparty relationships without external intervention, because it makes economic sense for the conduct of business. In short, "If it ain't broke, don't fix it." There is no substantiation

See p. 140.

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anywhere in the GAO report that privately negotiated derivatives activity is in any way broken and needs fixing.

Fundamental Misunderstandings

See comment 1.

The consideration of sales practices for mortgage-backed securities and structured notes in the same context as counterparty relations for privately negotiated derivatives is intellectually and practically inappropriate. ISDA suggested to the GAO when we commented on the initial draft survey that this grouping did not make sense either from a business or regulatory perspective. The confusing and incomplete differentiation between privately negotiated derivatives and these types of securities transactions throughout the GAO Report -- when discussing survey results, regulatory schemes, legal proceedings, and end user comments -- confirms our initial concerns that the final GAO report might not provide a clear and rigorous analysis of the issues.

See comment 1.

Mortgage backed securities and structured notes operate under a different legal and regulatory regime from privately negotiated derivatives transactions. As the GAO report indicates, they are regulated by the Securities and Exchange Commission (SEC) and, as securities which involve transfer of ownership, are subject to all of the National Association of Securities Dealers' (NASD) sales practice requirements. Privately negotiated derivatives transactions do not involve transfer of ownership but create obligations to exchange periodic payments over the life of the contract. By attempting to gloss over -- or failing to understand -- this fundamental difference between a security and a swap, the GAO has confused itself in fundamental ways, and may confuse some reader of the report. In fact, the GAO findings reveal higher losses and a greater dissatisfaction with the sales practices for regulated securities transactions than for privately negotiated derivatives, suggesting that a regime of this sort is not necessarily more effective in reducing problems.

See comment 2.

ISDA would also like to note that the definition of losses, by the GAO's own admission, may be flawed. It depends on publicly available information and self-reporting by end-users. The GAO indicates that "...we generally did not confirm the accuracy of the information provided by such sources. In addition, the reported loss amounts include realized and unrealized losses and may include losses associated with products not covered in this report." ISDA would like to emphasize the possible inclusion of **unrealized** losses in these calculations and further point out that in some cases, these "losses" may have been mitigated by gains on offsetting hedging transactions. Therefore, actual **realized** losses may be significantly lower than those reported by the GAO.

Scope of Derivatives Losses

See comment 3.

Although the GAO report does attempt to put derivatives-related losses in context, we believe that the report, nevertheless, obscures how small the losses are relative to total activity. In Chapter Three, the GAO Report estimates that the total **cumulative** losses in privately negotiated derivatives from April 1987 through December 1996 for both foreign and U.S. counterparties with U.S. entities were $5.3 billion overall, with the amount involving counterparty relationship

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concerns totalling $1.7 billion. According to the BIS, as reported by the GAO, the amount outstanding of privately negotiated derivatives was estimated at $47.5 trillion worldwide and $11 trillion in the United States as of March 31, 1995. The Federal Reserve, moreover, has estimated that the amount at risk, based on the gross market value of such derivatives held by U.S. entities, was $328 billion as of March 31, 1995. The amount at risk represents the gross market value of the transactions, rather than the notional amount of the contracts; however, since it does not attempt to take netting into account, this is clearly an overstatement.

See comment 3.

If the losses are compared to gross market value, total ten-year cumulative losses represent 1.6%, and ten-year cumulative losses involving counterparty relationship concerns total .5% of gross market value. An annualized total loss level of .16% of gross market value and an annualized loss level of .05% involving counterparty relationships are indicative of a vigorous and robust business activity. And this is predicated on the GAO's calculation of losses which, due to definitional problems, may overestimate any actual losses.

See comment 3.

We believe that the GAO should have given greater emphasis to the relatively small percentage of losses experienced by participants in privately negotiated derivatives transactions. In fact the derivatives-related losses involving counterparty relationship issues were a fraction of the total derivatives losses identified by the GAO. This level of loss over a ten-year period should reassure rather than prompt further investigation or intervention by regulatory agencies.

Current Regulatory Framework and Participant Practices Maximize Effectiveness, Minimize Costs

See p. 139.

The GAO Report derives conclusions and proposes recommendations that are inconsistent with the empirical evidence the report summarizes. On the one hand, throughout the report, the facts are presented that the instances of problems are minimal, that end users are satisfied with dealer practices, that the industry has taken steps in recent years to define and clarify the responsibilities and obligations in counterparty relationships, that the regulators have approved of the industry efforts and indicated that further regulations are not necessary; yet, the GAO suggests that "the market characteristics that contributed to the high level of end-user satisfaction and the limited number of sales practice disputes experienced to date could change as the markets evolve."

The GAO's documentation of the evolution of privately negotiated derivatives activity, however, illustrates how the issues of counterparty relationships for privately negotiated derivatives participants have already been addressed and continue to be addressed by market participants.
The rapid growth of swap activity, which has exceeded 30% per annum over the past decade, is a vivid demonstration of the success counterparties have achieved in establishing satisfactory relationships. A business this large is able to grow so quickly because the participants have successfully resolved these issues in thousand of bilateral discussions.

See comment 4.

In addition to successful bilateral resolution of counterparty relations, multilateral discussions may also have helped to illuminate these relationships. The "Principles and Practices for Wholesale Financial Market Transactions" (the "Principles and Practices") and ISDA's "Representation Regarding Relationship Between Parties" clause for documentation purposes

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have served as the basis for productive discussions between dealers and end users that clarify counterparty relationships. The implementation of the "Framework for Voluntary Oversight" within six securities firm affiliates has expanded and strengthened since its introduction in March of 1995. The SEC and the securities self-regulating organizations review dealer activities in privately negotiated derivatives, even without formal jurisdiction over swap dealing affiliates, with these cooperation of the securities firms.

See comment 4.

The only appropriate starting place for institutional participants in derivatives is an arm's length relationship. Parties are free to alter that relationship if they agree to do so, but variations must occur on a privately negotiated basis. The Federal government does not have a constructive role to play in the bilateral negotiations between parties that can take care of themselves. This point is recognized in the GAO Report which states "federal involvement may not result in an agreement that is widely accepted." In fact, additional regulation and the potential for increased litigation would only result in higher transaction costs with little offsetting benefit.

See comment 5.

In many instances the support the GAO cites for proposing regulatory intervention is anecdotal in nature (see Chapter 4 citations of conference speakers, etc.). We can also cite comments from end users in forums such as ISDA conferences who categorically reject the need for any governmental interference in setting the parameters of their counterparty relationships. In fact, even large end users who may not accept the inclusion of ISDA's "Representation Regarding Relationship Between Parties" language in transaction documentation, view this as a matter for bilateral negotiation, not regulation.

See comment 6.

Rather than advocating expanded regulatory activity, the GAO Report should have emphasized in its recommendations the need for consideration and understanding of the internal control and risk management recommendations in the Group of Thirty report that was published in July 1993. Those recommendations, as well as recommendations from the Treasury Management Association in its October 1995 report "Voluntary Principles and Practices : Guidelines for End Users of Derivatives", emphasize the need for both dealers and end users to adopt corporate policies and procedures for risk taking and management. Internal policies and procedures are the most effective way to minimize the potential for inappropriate transactions and financial losses. According to the GAO Report, "End-users reported lower rates of dissatisfaction with the sales practices of dealers they had used than for dealers that had made presentations to them but were not used." This is strong evidence for the case that informed end users are able to differentiate among dealers and make their own informed selection of counterparties.

Conclusion

See comment 6.

We believe that the findings of the GAO Report support ISDA's recommendation that firms should focus on internal controls and procedures as a way to provide the best protection for an end user. We would suggest that the GAO reflect this view in its final recommendations. In addition, the GAO's specific recommendation to involve the President's Working Group in the dialogue between end users and dealers on the nature of their counterparty relationships is not necessary or appropriate given the GAO's own findings.

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If you have any questions as you review this letter, please do not hesitate to call me or any ISDA Director. We look forward to continuing our dialogue with the GAO. Specific corrections on the GAO Report are attached.

Sincerely,

Gay Evans

Gay H. Evans
Chairman

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The following are GAO's comments on the International Swaps and Derivatives Association's August 15, 1997, letter.

GAO Comments

1. The association commented that the report's consideration of sales practice issues for mortgage-backed securities (MBS) and structured notes in the same context as those for over-the-counter (OTC) derivatives is intellectually and practically inappropriate, and that the report is confusing and incomplete in differentiating between these transaction types. The association also noted that the report found that greater losses and more dissatisfaction existed for MBS and structured notes than for OTC derivatives, even though the former are subject to the securities laws—suggesting that regulation is not necessarily effective in reducing problems.

We attempted to ensure that this report distinguishes, as appropriate, among OTC derivatives, MBS, and structured notes. As our report states, it addresses sales practices for the three product categories because losses associated with each of them were receiving public and regulatory attention at the time we began our review. Furthermore, although we agree with the association that significant differences in the products and their regulatory schemes exist, the products share many risk characteristics and are frequently marketed by the same dealers and used by many of the same market participants. As a result, by including all three product categories, our report provides useful information to those trying to understand the similarities and differences among the sales practice requirements for the OTC markets.

The association's conclusion that the higher level of disputes and dissatisfaction associated with MBS and structured notes indicates that the regulatory regime is not fully effective is open to question. First, the bulk of MBS and structured notes are government securities that are issued by government-sponsored enterprises (GSE) and marketed by broker-dealers. However, as our report notes, the National Association of Securities Dealers (NASD), a self-regulatory organization with oversight responsibilities for a significant number of MBS and structured note dealers, was limited in its ability to assess the marketing of GSE-issued securities against its full complement of sales practice rules by a long-standing statutory restriction. This restriction was removed by the Government Securities Act Amendments of 1993. Nonetheless, NASD rules governing GSE-issued securities were not approved until August 1996. As this report states, the removal of this restriction and implementation of these rules should improve the oversight of this products, which may, over time, lead to a reduction in sales practice-related complaints.

Second, the higher level of sales practice-related disputes and dissatisfaction associated with MBS relative to OTC derivatives may be partly attributable to the lower level of sophistication of MBS end-users compared to that of OTC derivatives end-users. Also, because MBS involve the transfer of ownership, the dealer and end-user do not have an ongoing relationship vis-a-vis a specific transaction. As a result, an unethical dealer may find MBS end-users more vulnerable targets when contemplating committing fraud.

2. The association commented that the definition of losses as discussed in the draft report may be flawed. The association noted that loss totals included in the report were compiled from public information and depended on end-user self-reporting. It also noted that steps to confirm their accuracy had not always been taken. Furthermore, it noted that actual losses may be significantly lower than those reported because of the inclusion of unrealized losses, which may have been mitigated by offsetting hedging transactions.

Our report now acknowledges not only the limitations and weaknesses that exist in the loss totals but also the potential that losses may be overstated by including unrealized losses and understated by omitting losses that were not publicly reported. Because of these limitations, we used this information only as one indicator of the extent of sales practice concerns and supplemented it with data from regulators, our survey of end-users, and discussions with market participants and regulators.

3. The association commented that while the draft report attempts to put the level of losses in context, it obscures how small the losses are relative to total market activity. The association provided calculations comparing the losses we reported to the gross market value of OTC derivatives outstanding in the United States, as of March 1995. The association concluded that we should have emphasized the resulting relatively small loss percentage when explaining that sales practice-related losses did not appear to be widespread.

We added text to the loss discussion in chapter 3 that recognizes sales practice concerns are not widespread relative to the limited number of dealers involved in the losses that have been reported, the thousands of transactions that have occurred over the period discussed, and the hundreds of billions of dollars at risk in these transactions. We did not use the loss data that we developed to perform calculations such as those the association presented due to its limitations. Doing so would have suggested greater precision in and validity to the statistical results than is otherwise warranted. Notwithstanding this objection, comparing the cumulative loss total for multiple years to the amounts outstanding as of a single later year, as the association did, is not appropriate. Because losses on transactions initiated in one year may not be incurred until several years later, a more relevant analysis would be to compare losses on transactions initiated in a single year to the amount at risk in transactions initiated during that same year. However, data to make such calculations were not generally available.

4. The association commented that the two sets of dealer-issued guidance served as the basis for productive discussions between dealers and end-users for clarifying counterparty relationships and noted that the only appropriate starting place for institutional participants in derivatives is an arm's-length relationship. The association stated that the parties are free to alter such a relationship if they agree to do so, but such variations should occur on a privately negotiated basis. Furthermore, the association stated that the federal government does not have a role to play in bilateral negotiations between "parties that can take care of themselves," and that additional regulation and the increased potential for litigation would only result in higher transaction costs with little offsetting benefits.

We agree that the dealer-issued guidance has provided opportunities for discussion between dealers and end-users. However, our survey results show that end-users attribute fiduciary responsibilities to and rely on dealers as part of OTC derivatives transactions. Also, end-users and others have objected to the presumption of an arm's-length relationship as evidenced in the formal comments these groups submitted on one set of guidance—the Principles and Practices for Wholesale Financial Market Transactions. This evidence indicates a lack of acceptance and/or understanding of the specific responsibilities the dealer-issued guidance asserts for OTC derivatives transactions. Our recommendation calls for the federal regulators that participate in the Working Group to consider whether they can assist in bridging this lack of agreement or understanding. We do not anticipate that the Working Group would dictate the nature of the relationship that should prevail because this would fail to account for the inevitable and appropriate differences in the actual relationships between parties. Instead, the Working Group could facilitate discussions between dealers and end-users that might lead to agreement in key areas where they now disagree.

5. The association asserted that in many instances our support for proposing regulatory intervention is anecdotal. We do not rely on anecdotal information to support our recommendations. Rather, such information is used primarily to illustrate the results provided by our survey and to provide insights into other data we obtained—such as end-users' formal comments on the Principles.

6. The association commented that the draft report should have emphasized in its recommendations the need for universal implementation of and adherence to the internal control and risk management recommendations in the Group of Thirty report published in July 1993. We recognized the importance of internal controls in two previous reports on derivatives.[3] The May 1994 report makes three recommendations to one or more of the federal financial market regulators on this subject. The inclusion of chapter 5 in this report—discussing guidance to dealers and end-users related to sales practice issues and describing dealer and end-user efforts to implement related internal controls—reflects our continued concern about the adequacy of market participants' internal controls and our support for efforts to improve them. Implementing controls such as those advocated by the Group of Thirty and others could significantly reduce dealer and end-user exposure to the type of compliance and reputation risk losses that can arise from engaging in transactions involving OTC derivatives and other financial products.

[3]See Financial Derivatives: Actions Needed to Protect the Financial System (GAO/GGD-94-133, May 18, 1994) and Financial Derivatives: Actions Taken or Proposed Since May 1994 (GAO/GGD/AIMD-97-8, Nov. 1, 1996.

Comments From the National Association of State Auditors, Comptrollers and Treasurers

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

National Association of
State Auditors, Comptrollers and Treasurers

July 28, 1997

Ms. Jean Gleason-Stromburg
Director, Financial Institutions
and Markets Issues
General Government Division
United States General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Gleason-Stromburg:

The National Association of State Auditors, Comptrollers and Treasurers (NASACT) appreciates the opportunity to respond to the General Accounting Office's (GAO) draft report, OTC Derivatives: Additional Oversight and Guidance Could Reduce the Potential for Costly Sales Practice Disputes.

NASACT represents the key state fiscal officers responsible for the management and investment of billions of dollars of taxpayer funds. In this regard, NASACT members are highly involved in the issues addressed by the report. As end-users of many types of financial instruments, including over-the-counter derivatives, mortgage backed securities, and structured notes, our members have a compelling interest in ensuring that proper sales practices are followed to protect the integrity of public funds.

See comment.

Overall, the report provides an excellent study of sales practice issues facing the OTC derivatives market. However, in several places the report notes that the majority of end-users of derivatives were "generally satisfied" with sales practices exercised by banks and broker-dealers. The results are based on a G.A.O. survey that originated March of 1995. Therefore, the survey results may not reflect sales practices influenced by the Framework for Voluntary Oversight (Framework), issued in March of 1995, or by The Principles and Practices for Wholesale Financial Markets Transactions (Principles), issued in August of 1995. End-users that were "generally satisfied" with sales practices in 1995 may not be satisfied today due to the promulgation of the Framework and the Principles.

The Framework was drafted by the Derivatives Policy Group (DPG), six securities firms active in the OTC derivatives market, with input from the U.S. Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). No end-users were included in the DPG. The Framework is intended as a guide for professional market participants and proposes that it be applied to any

Relmond P. Van Daniker, Executive Director for NASACT
2401 Regency Road, Suite 302, Lexington, Kentucky 40503, Telephone (606) 276-1147,
Fax (606) 278-0507, email rvnasact@mis.net and 444 N. Capitol Street, NW, Washington, DC 20001
Telephone (202) 624-5451, Fax (202) 624-5473, email nasactdc@sso.org

affiliate of an SEC registered broker-dealer. In its section titled, "Counterparty Relationships," the report describes the relationship of broker-dealers to nonprofessional counterparts to be predominantly at "arms-length," or with no fiduciary responsibility existing between parties. The Framework does outline certain situations when the broker-dealer is obligated to clarify its role in a transaction if it becomes aware that a nonprofessional counterparty wrongly believes that it the broker-dealer is acting in an advisory capacity.

The Principles, drafted by several OTC derivative dealer associations under the auspices of the Federal Reserve Bank of New York, determined that all transactions on the OTC derivatives market were considered at "arms-length." In addition, the Principles are intended to apply to all market participants, even those that do not know of their existence, including nonprofessional end-users.

The Principles state that professional market participants are under no obligation to volunteer more than a minimal amount of information to counterparties regarding transactions. A counterparty is considered to be fully aware of the risks inherent in all transactions where a written agreement stating otherwise does not exist. A counterparty that is not familiar enough with a transaction to question its merits is considered the professional's equal.

NASACT was one of several end-user groups asked to provide input on the Principles prior to issuance. No substantive revisions were enacted as a result of NASACT's participation. A meeting scheduled a few months ago by the Federal Reserve Bank of New York to discuss revisions to the Principles was abruptly postponed with no alternative date planned.

NASACT agrees with the report's recommendation that the President's Working Group on Financial Markets monitor the OTC derivatives markets to ascertain if additional sales practices guidance is needed and that it assist end-users and dealers in reaching agreement on the nature of the counterparty relationship.

NASACT also agrees with the recommendation that the Federal Reserve implement revised exam guidance regarding risk disclosure, creating advisory relationships, and supervising marketing personnel.

See p. 142.

While agreeing that its guidance is preferable to the Principles, NASACT does not agree with the report's recommendation that the SEC and CFTC establish mechanisms to determine the compliance of firms following the Framework's sales practice provisions. The Framework and the Principles were established as guidelines and both expressly state that they are not meant to establish any new legal obligations. SEC and CFTC participation in a compliance program would be recognized as an endorsement and would certainly present new legal obligations without being subject to the due process associated with new regulation.

Effective regulations are developed with adequate opportunity for input and comment from all parties involved. The final recommendation would not result in successful regulation.

NASACT proposes that the drafters of the Framework and end-user participants, together with the SEC and CFTC, meet to further clarify counterparty relationships. A joint project with true cooperation would benefit all market participants.

Thank you again for inviting NASACT to comment on your draft report on the OTC derivatives market.

Sincerely,

Margaret Kelly/SKK

Margaret B. Kelly, CPA
President, NASACT

The following is GAO's comment on the National Association of State Auditors, Comptrollers and Treasurers' July 28, 1997, letter.

GAO Comment

The association commented that end-users who were generally satisfied with dealer sales practices at the time of our 1995 survey may not be satisfied with them today due to the promulgation of the Framework for Voluntary Oversight and the Principles and Practices for Wholesale Financial Market Transactions. The association elaborated that no end-users were included in the Derivatives Policy Group that issued the Framework, and no substantive revisions were made to the Principles as a result of the association's input.

End-user comments on the provisions of these documents, including those that the association discusses in its letter, are discussed in this report. Our report also recognizes that the market characteristics that contributed to the relatively high level of end-user satisfaction and the relatively limited number of sales practice disputes could change as the markets evolve. For this reason, we recommend that the President's Working Group on Financial Markets establish a mechanism for systematically monitoring developments in the over-the-counter derivatives markets to assess whether developments warrant introducing specific federal sales practice requirements.

Major Contributors to This Report

General Government Division, Washington, D.C.

Cecile O. Trop, Assistant Director
Cody J. Goebel, Co-project Manager
James R. Black, Senior Evaluator
Frederick T. Evans, Senior Evaluator
Rosemary Healy, Attorney
Christine J. Kuduk, Evaluator
Carl M. Ramirez, Senior Social Science Analyst
Desiree W. Whipple, Communications Analyst

Chicago Field Office

David J. Diersen, Co-project Manager
Melvin Thomas, Sub-project Manager
Daniel K. Lee, Evaluator
Cristine M. Marik, Evaluator
Angela Pun, Evaluator
Richard S. Tsuhara, Senior Evaluator
Francis M. Zbylski, Senior Operations Research Analyst (Retired)

Office of Special Investigations

Donald F. Fulwider, Deputy Director

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