REMARKS OF

COMMISSIONER J. CARTER BEESE, JR.*
U.S. SECURITIES AND EXCHANGE COMMISSION

A ROADMAP TO SEC REGULATION OF DERIVATIVES ACTIVITIES

INTERNATIONAL SWAPS & DERIVATIVES ASSOCIATION CONFERENCE

WASHINGTON, D.C.
NOVEMBER 3, 1993

* The views expressed herein are those of Commissioner Beese and do not necessarily represent those of the Commission, other Commissioners, or the staff.

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

In the words of that great Western philosopher Groucho Marx, "Before starting my speech, I have something important to say."

First, I do not believe that derivatives will be the next S&L crisis. And second, that does not mean that there is no reason for concern and that no regulatory action is necessary.

I wanted to clarify these two points before proceeding today because after reading press reports about last week's hearing on derivatives in the House Banking Committee, I wasn't sure that I had attended the same hearing. Let me explain why.

As I'm sure many of you are aware, some have called for severe restrictions on derivatives activities warning that derivatives will be the "next S&L crisis." These commentators generally fall into two categories. The first group I would call "conscienscious objectors." They can cite from memory the recent excesses of Wall Street -- some of which they are still paying for, they believe in the general notion of free and unfettered markets but also recognize the role of prudent regulation, and they see red flags going up over the explosive growth of the derivatives market.

The second group I would call the "never again" crowd. This group failed to see the coming of the S&L crisis and are determined not to make this mistake again. They are less concerned with making the right analysis than with ensuring that if another financial debacle does occur, they will be on record having predicted it. By their way of thinking, its better to have predicted ten crises that do not occur than to miss one that does.

Some on Wall Street think that everyone in Washington belongs in the "never again" category. That Washington really doesn't understand the markets and that everyone in this town is some type of modern day financial Luddite. I'm here to tell you that is not the case. Most people in this town recognize that derivative activities do have a role to play in sound financial management, but they want some assurance that regulators are up to the task of understanding and overseeing this market.

As a regulator, I don't believe you can navigate the twists and turns of the regulatory landscape ahead by looking exclusively in the rear-view mirror. While there certainly are lessons to be learned from prior experiences, including the S&L crisis, there are "cops on the beat" with regard to derivatives.

Is this to say that I am unconcerned with the explosive growth of the derivatives market. Absolutely not. As a regulator, it's my job to be concerned. My message to the House Banking Committee last week was not -- "don't worry, be happy." My message was that the SEC currently has the tools necessary to police this market and that we are committed to vigorously using these tools.

From a regulatory perspective, what concerns arise with regard to derivatives activities and what is the SEC doing to mitigate these concerns? During periods of market stress, concerns arise with regard to the possibility of a "ripple effect" and the impact of derivatives activities on the liquidity of the cash market. Under a potential ripple effect, the increased use of derivatives could lead to the failure of one or more derivatives dealers with this failure creating ripple effects throughout the OTC derivatives market for broker-dealers and market participants. Similarly, in an extreme market stress environment, the liquidity of the nation's equity markets could be strained by the sell-off of stocks and futures by derivatives dealers trying to adjust their hedges to accommodate rapidly changing market risks.

While I don't want to overstate the magnitude or likelihood of these types of market reactions to extreme market stress, I do think it is safe to say these would be low probability, high impact events.

In addition to these concerns, the SEC has three areas of concern that apply to all markets, including derivatives markets. These are full disclosure, customer suitability, and anti-fraud protection. To address these concerns there are four general themes to SEC regulatory oversight of derivative activities.

The first is <u>risk assessment</u>. In order to properly regulate this market we must first know its size and scope. Accordingly, last year the Commission adopted a risk assessment program which requires securities firms to report on a quarterly basis the size of their derivatives exposure in terms of both notional amount and replacement cost value. The Commission's staff is presently analyzing quarterly filings received from approximately 250 broker-dealers with over 700 significant affiliates. Based on current numbers, the approximate notional amount of derivatives activity for the major U.S. broker-dealers and their affiliates is approximately $4 trillion with an aggregate replacement cost of OTC derivatives of approximately $18 billion.

The second theme of SEC oversight is <u>capital</u>. Strong capital requirements serve as an essential regulatory tool in protecting customers and mitigating systemic problems. In May of this year, the SEC asked for public comment on a broad range of issues relating to the appropriate capital treatment of derivative products under the Commission's net capital rule. In examining the treatment of derivative products, the Commission's concept release focused *on the market and credit risk to which participants in the derivative products market are exposed. Along with focusing on the risk profile, the concept release seeks to address the unintended disincentives that exist in our current capital rule to effecting these transactions in the registered broker-dealer. Our overriding goal in this review is to strike the appropriate balance between safety and the efficient use of capital.*

Our third theme is ***accounting****. It is axiomatic that good accounting is the underpinning of good risk management and good regulatory oversight. To the extent that settlement values under derivatives contracts are largely contingent, which is often the case throughout the life of a derivative contract, current accounting standards do not require settlement values to be reflected in the firms' balance sheets.*

We must encourage international efforts to harmonize accounting treatment of off-balance sheet items. An important step in this direction is the recent issuance by the Financial Accounting Standards Board of accounting standards governing the disclosure of information about the nature, extent, and terms of financial instruments with off-balance sheet credit or market exposure. Public companies that have material exposures as a result of current or contemplated transactions in derivatives are also required under SEC rules (Regulation S-K, Item 303) to discuss the commitments and uncertainties that *may have a material effect on liquidity or operating results in the future. The FASB is also studying ways to address the accounting treatment of swaps and other derivative products as part of its comprehensive review of new financial instruments.*

The final theme of SEC oversight is coordination. A cooperative dialogue and information-sharing among regulators and market participants is essential to understanding the aggregate size of the market and properly identifying potential systemic stress points. In its' recently released study on derivatives, the CFTC recommends formation of an "interagency council" to fulfill this coordination function. A substantial amount of informal coordination occurs now, and I certainly support the CFTC's call for formalizing this process -- but I'll leave a decision as to how best to achieve this coordination to others more versed in the language of "reinventing government."

SEC: GOOD STORY TO TELL

By and large, I believe the SEC has a good story to tell with regard to regulatory oversight of derivatives activities. We have moved with dispatch on risk assessment and capital, and are committed to working with fellow regulators on enhancing coordination. The one area where I believe more must be done is in the area of accounting standards.

The financial statements of entities with OTC books far in excess of their capital are, for all intents and purposes, opaque. That lack of transparency means that the OTC derivatives mantra, "know thy counterparty" requires much more than a traditional analysis of their balance sheet disclosure. For the first time in recent memory, you can't assume that by looking at a firm's balance sheet you can adequately understand their business.

The rapid growth of the derivatives market, and in particular the introduction of new products and strategies, has left the accounting profession behind the curve. At the present time, GAAP simply does not comprehensively address the manner in which public companies must account for and disclose their derivative activities. While some footnote disclosure and MD&A discussion is presently required, the FASB and the Commission must do more in this area.

That's my candid assessment of how the regulators have done so far with regard to overseeing derivatives activities. The next question is "how good is the industry's story?" The first step in mitigating systemic risk is to ensure sound risk management at the individual firm level. In other words, the best way to prevent the "ripple effect" is to keep that first firm from falling into the lake.

G-30 REPORT

The Group of Thirty's study on derivatives makes a significant contribution to the better understanding and management of the derivatives market. I have long believed that the real issue is not how regulators should regulate this market, but how dealers and end-users should manage it.

In my view, the most significant recommendations in the G-30 report were the first and the last. First, the report recommended that the highest levels of senior management must pay attention to their firms' derivatives activities. This recommendation included a suggestion that a firm's policies for derivatives should be an integral part of its overall policies for risk taking and management. I would suggest that firm management should -- and, in fact, must -- go further than that. The anecdotal evidence in the report that senior management is worried about its own lack of understanding of OTC derivatives and about its over-reliance on specialists is somewhat troubling. Senior management must not only "pay attention to firms' derivatives activities," but also must develop a thorough understanding of the products, the risks their firms assume because of this activity, and the manner in which those risks are managed and controlled.

In addition to senior management taking an active role in overseeing this business, board audit committees should make sure that firm internal and external auditors are asking the right questions, including identifying a group in the firm primarily responsible for risk management; whether they are separate from the traders who are incurring the risk; whether this valuation group arrives at the assumptions in their pricing models independently or receives key input data from the originator of the trade; whether internal controls and information systems are reliable and working well; and whether credit exposure to specific counterparties is being marked to market. Also critical is centralized risk management for the holding company and its subsidiaries.

The last recommendation in the G-30 report is for the industry to voluntarily adopt accounting and disclosure practices for international harmonization and greater transparency, pending the arrival of international standards. As I stated earlier, the lack of harmonized accounting standards is looming larger on the horizon as one of the biggest and possibly most difficult issues dealers, end-users, and regulators will confront in this market.

In my view, the question is not if more comprehensive accounting standards will be adopted, but when. I encourage market participants to take a proactive approach on this issue and get ahead of regulators by adopting voluntary industry guidelines that will facilitate accounting transparency.

CONCLUSION

We are at an important cross-road in the development of the derivatives market. The Bank of England, Bundesbank, IMF, and CFTC have all issued reports on this market and a GAO report is due out before the end of the year. The Bundesbank issued a fairly cautionary report and one GAO commentator has already stated publicly that their study will draw analogies to the S&L crisis.

The bottom line is that the clock is ticking in Washington. That should underscore the urgent need for market participants and regulators to work together to resolve the issues I have raised today. The G-30 was a good start. If the market players continue forward in the spirit of the G-30 study then regulators will have much less to do. And as an industry you will have a much better story to tell Congress.

And make no mistake about it, you will have plenty of opportunities to tell your story to Congress. The House Banking Committee hearings were the first of many. Chairman Markey has already announced his intention to hold hearings coinciding with the release of the GAO study. And I'm sure the Senate committees won't be far behind.

Our challenge, both as regulators and as market participants, is to continue to encourage innovation and product development to better meet the needs of end-users. While at the same time, we must ensure the continued integrity and stability of the marketplace.

Remember, regulators around the world are watching. The industry can work constructively with the SEC along the lines of the G-30 recommendations or, in the alternative, you may find yourselves on C-Span in front of a congressional committee explaining why you won't be the next S&L crisis. That's obviously an outcome we would all like to avoid.

Thank you.