

**NEW DERIVATIVES INSTRUMENTS:
THE ROLE OF THE REGULATOR**

An Address by

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I. INTRODUCTION

It is my pleasure to be here today to speak at the Euromoney Conference on Investing in Global Derivatives. Commissioner Schapiro asked me to relay her regrets at not being able to speak at the Conference.

Before I go much further I have to give you the traditional Securities and Exchange Commission ("SEC" or "Commission") disclaimer statement: the statements I make today are my own and do not necessarily represent the views of the Commission or my colleagues on the staff of the Commission. The Commission as a matter of policy disclaims responsibility for any statements I make today.

I have been asked to speak today on the topic of the role of the regulator in new derivative instruments. The monumental growth in derivative products worldwide has generated a tremendous amount of media coverage and regulatory attention. As markets and professionals create new products as a dizzying pace, regulators and legislators are analyzing how to address the rapid growth in these products. While I cannot claim to have ready answers to all of the questions, I would like to present some thoughts on these products and a regulatory perspective from the U.S.

II. Standardized Markets

The growth in derivative products has occurred in two different groups of products. The first is standardized derivative products, that is, those

traded on an exchange and cleared through a centralized clearinghouse. The second are over-the-counter "(OTC)" derivatives, such as swaps, collars, and derivative-linked debt that are traded in private transactions between institutions. I will divide my talk between these two product lines, because they raise somewhat different issues for regulators.

Until the mid 1980s, only the U.S. had active and liquid options and futures exchanges. Recently, standardized derivatives have taken off in markets around the world. Now there are active markets in Japan, several European countries, and several Asian countries, and emerging markets around the world are exploring the possibility of starting an options or futures exchange.

I believe the U.S. securities options markets, which are regulated by the SEC in the U.S., are a valuable national asset which provide important hedging asset allocation opportunities for investors. At the same time, due to the complex nature of options, their leverage, and the fact that they are a wasting asset (in that they expire), a special regulatory regime has been developed for options. These rules are designed to protect investors and maintain fair and orderly markets, while still facilitating the development of new products as well as market competition and efficiency. I would like to describe briefly these rules for you.

* Sales practice rules: adequate supervision of options require broker-dealers to actively and continuously ensure that knowledgeable

supervisory personnel oversee the practices of their salesmen, that their salesmen are adequately trained, and that they transact business only with those investors who can appreciate and bear the risks which stock, stock index and currency options trading entails. We have required that the options trading rules of the self-regulatory organizations ("SROs") require heightened suitability standards for options transactions of customers. The rules of the SROs prohibit member firms from recommending to any customer any options transaction unless they have reasonable grounds to believe that the entire recommended transaction is not unsuitable for the customer on the basis of information furnished after reasonable inquiry concerning the customer's investment objectives, financial situation and needs. In addition, the SROs, with SEC oversight, have implemented a program of options account regulation that includes several other special rules regarding account opening procedures, discretionary trading, customer complaints, and sales advertising.

* **Margins:** it is important to establish a prudential margin system that takes into account the potential for systemic risk. The SROs and SEC have established a premium-based margin system for "short" options positions. Under this uniform system, the options exchanges and the NASD have set appropriate margin levels consistent with market conditions.

*** Disclosure: options are securities, and thus subject to the disclosure rules of the U.S. federal securities laws. The SEC has devised a special disclosure regime for options that requires broker-dealers to provide options customers with a copy of an options disclosure document containing information on the characteristics and risks of options trading. The broker-dealer must provide the disclosure document prior to the time the customer begins trading options.**

*** Surveillance: the SROs and Commission have developed special rules applicable to options trading to prevent intermarket abuses. These rules include frontrunning prohibitions and position limits. There also are circuit breakers in place for derivatives that are designed to dampen market stress during periods of short-term volatility. In addition, each options exchange is required to have in place a comprehensive surveillance system designed to detect fraudulent and manipulative practices involving options.**

*** Regulatory Cooperation: regulators have special surveillance concerns for derivative products based on foreign indices. For these products, the SEC has tried to ensure that there are adequate surveillance sharing arrangements between the market trading the derivative product and the market trading the underlying stocks.**

The special regulatory regime for standardized options – sales practice rules, options disclosure document, proper margins, adequate surveillance,

and surveillance sharing agreements – have worked well in the U.S. Over the past seven years, however, new types of standardized derivative products have been introduced that do not always fit cleanly into the existing regulatory structure. Specifically, in recent years in the U.S. and Europe, market participants have developed useful financial products, commonly called "hybrids", that combine elements of equity, debt, and derivative products. For example, instead of issuing straight debt, a company with overseas business exposure could issue notes with part of the interest tied to a foreign currency. Because the company is taking on some foreign currency risk, it can issue the debt cheaper than if the debt was dollar-denominated.

Hybrid products have provided corporations with a flexible and cost-effective means of raising capital, and can be an attractive alternative to traditional debt or equity offerings. Several billion dollars have been raised publically in the past five years in the U.S. alone from the sale of hybrid products. Corporations such as Xerox, Ford, and Sohio have issued these products. They have also created hybrid products such as currency and index warrants and various forms of convertible preferred stock that serve similar purposes. While not all of the hybrid offerings reach a public market, many are listed on exchanges and distributed to retail investors.

Aside from corporate issuers, the organized exchanges themselves have invented new forms of derivative products. As a recent example, the

American Stock Exchange trades so-called "SPDRs", which are similar to an open-ended S&P 500 fund that trades like shares of stock.

The role of the regulator towards these new products has two objectives. First, the regulator should ensure that the existing rules, when applied to these products, adequately protect investors and address any potential for systemic risk. At the same time, the regulations should be designed to allow for new product creation and experimentation. To meet both these objectives, the regulators will have to be flexible and forward-looking, while bearing in mind the public responsibilities that have been entrusted to them. In the U.S., the SEC and SROs have tried to meet this challenge by crafting new "hybrid" rules that combine elements of options regulation with traditional equity and debt regulation in the areas mentioned above, such as sales practice and disclosure. While this has worked well for hybrids traded on public markets, regulators are now faced with a new challenge with the growth of OTC derivatives, which comprise the second half of my presentation.

III. OTC Derivatives

Perhaps no subject has received as much media attention and regulatory scrutiny over the past year than OTC derivatives. These products began as an institutional market for shifting currency and interest rate risk, but now has expanded into a market of numerous products covering many different

asset classes. Current estimates are that there are outstanding instruments with a combined notional amount of several trillion dollars. Most of these cover interest rate obligations, with a minority covering currencies and a smaller amount covering equities and commodities.

To some extent, the notional amount figure is misleading. In reality, the notional amount is the principal amount of the underlying asset against which contract terms are multiplied to determine required cash flows. It can be argued that this reference amount is not the best measure to determine the real risk exposure on a specific contract to one of its parties. Perhaps it might be better to calculate actual risk by looking at the replacement cost or the mark-to-market value of the instrument, which is typically only 2-3 percent of the notional amount. A recent study by U.S. banking regulators found that the ten largest U.S. bank holding companies had a total replacement cost credit exposure of \$170 billion dollars for their combined derivative contracts, excluding futures contracts, or about 17 percent of their total assets. While I do not want to minimize the size of those numbers, it must be kept in mind that they are not really larger than the companies' exposure on direct holdings of U.S. government securities and far lower than their credit risk in aggregate loans.

The success of the OTC derivatives market comes from the products' flexibility: with OTC derivatives, customers can craft hedges that correspond closely to their portfolio risk and adjust potential returns of various asset

classes in different ways. In addition, OTC derivatives allow institutions to gain exposure to equity, bond, or mortgage markets without having to liquidate certificate of deposits or Treasury securities. This all comes at a price, as users of OTC derivatives take on credit risk and give up the liquidity that is available with standardized derivatives.

While the OTC derivatives market has been a large success, I do not want to give the impression that there are not serious risks involved in this markets. Indeed, those responsible for the regulation of various types of financial institutions should be carefully examining this market. In this regard, there are at least five studies underway in the U.S. on the subject, perhaps another five in other countries, and a keen interest by the U.S. Congress on the proper regulatory approach to these products.

An underlying premise to all of these studies has been that these products for the most part have been lightly regulated, and it is important to determine whether this is bad in terms of regulatory risks or good in terms of letting the market get established. As I mentioned earlier, I do not profess to have the answer today to these types of questions. I would, however, like to spend a few minutes discussing the types of risks that regulators should be analyzing when studying this market.

Leverage. It should come as no surprise that the degree of leverage of financial institutions is one of the most fundamental regulatory concerns. In applying the net capital rule to these products, the SEC has traditionally

followed an approach that treated the replacement value of swaps as unsecured receivables, and as a result applied a complete 100% writeoff to any such asset. While this approach clearly reduces imprudent leverage, it has essentially forced derivative exposures out of the regulated broker-dealers and into affiliated entities. We realize that this approach needs to be reexamined.

The SEC has taken several steps to addressing this problem. First, the Commission has begun requiring reporting of the size of exposures in such affiliates as part of the new holding company risk assessment program. Also, the SEC recently issued a concept release to solicit the market's views on the kinds of risk, as well as the level of risk, that dealers in this market are assuming. The concept release asks for comments and recommendations on how the SEC should respond to these risks. I want to be clear that the concept release does not offer any conclusions. Its main purpose is to determine if the Commission can remove the incentive in the current capital rules to effecting these transactions outside of the registered broker-dealers.

Market Impact. As with leverage, market impact is a traditional focus for SEC attention. When a customer uses OTC derivatives to shed market risk, the risk does not vanish but is merely shifted to the dealer issuing the derivative. In trying to hedge these positions, dealers can run into liquidity problems, especially in covering dynamically-hedged positions. The

replacement cost for a hedge under normal conditions can be dramatically different than the replacement cost under market stress. Anything that could cause a sudden liquidity demand on the market needs to be very carefully considered.

Credit Risk. Credit risk, on the other hand, is an area where banking supervisors traditionally have experience and have developed methodological and practical skills. It will be important for securities regulators to become more skilled in this area as derivative activity shifts away from clearinghouse instruments.

Concentration. The concentration of derivatives positions is an important regulatory issue. The swaps market is much more concentrated than traditional lending or securities markets, with fewer players and larger relative sizes of specific positions. As a result, it will be as important for regulators to examine concentration limits as it will be to develop capital requirements. The usual practice of dealers and end users is to look for the strongest counterparties. In the future, this practice may be negated by the risks of concentration, especially given that unexpected problems could occur to even the largest or most solvent of banks or broker-dealers. While market participants should not be unduly constrained in their activities, regulators will have to monitor concentrations of risk in OTC derivatives as well as the absolute size of exposures.

Internal Controls. Swaps and other OTC derivatives can be highly complex, and there is a need for management to exercise careful controls over and responsibility for their risk management systems. Because these instruments are new, evolving constantly and more technical and complex than traditional products, risk management controls are, relatively speaking, even more important than normal. This is one of the areas of inquiry for the SEC in evaluating broker-dealers under the risk assessment program. Regulators will expect firms to know who is responsible for decisionmaking, and to have in place systems to manage risktaking activities.

Systemic Risk. From a macro perspective, OTC derivatives also have the potential to raise the level of systemic risk in the markets. By that I mean the possibility that a failure of one counterparty in this market could have a domino effect on other counterparties. This will be a very difficult risk for regulators to gauge.

Suitability. While this market began with only the most sophisticated institutions, the customer base may be reaching the next tier of institutions. These products may not be suitable for all institutions, and it is important for dealers to keep this in mind as they shop these products.

IV. Conclusion

I have given a quite lengthy list of regulatory issues concerning OTC derivatives. I do not want to give the impression that the length means that

regulators need to come down with a heavy handed response. As with hybrid products, regulators will have to be flexible and forward thinking with OTC derivatives. Over the next year, securities, banking, and commodities regulators will be trying to do just that. The optimal outcome will be to arrive at an approach that maintains stable markets, while allowing market participants the freedom to continue to meet customer needs with new and innovative solutions.

Thank you for your attention, and I would be happy to answer any questions.