



98-19
16

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

RECEIVED
C.F.T.C.

1998 SEP 10 A 10:24

OFFICE OF THE SECRETARIAT

September 9, 1998

Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

COMMENT

SEP 10 1 46 PM '98
COMMODITY FUTURES
TRADING COMMISSION
RECEIVED FOR
PUBLIC RECORD

Dear Ms. Webb:

The End-Users of Derivatives Association ("EUDA") appreciates the opportunity to provide comments on the Commodity Futures Trading Commission's "Concept Release on Over-the-Counter Derivatives."

Summary of Comments

- Not all end-users possess the same level of sophistication when it comes to derivatives.
- The CFTC should not unilaterally add additional regulations to the OTC derivatives market or impose higher standards on dealers to protect less sophisticated end-users.
- Instead, the CFTC should encourage, if not facilitate, the establishment of an alternative to the OTC market for less sophisticated end-users where they can access risk management tools in a more controlled environment ("alternative facility").
- A federal agency (not necessarily the CFTC) should possess antifraud enforcement authority over the OTC derivatives market.
- Meaningful end-user participation should be added to the President's Working Group and it should make a recommendation to Congress on which agency should have jurisdiction over both the OTC derivatives market and the alternative facility.
- The goal of any regulatory action by any agency, not just the CFTC, in the interim should be limited to providing greater legal certainty and greater competitiveness.

EUDA

EUDA was formed to promote the interests of end-users of derivatives. EUDA has approximately 60 members representing a broad spectrum of America's industrial, commercial and financial businesses. It is intended to serve as an independent end-user resource, disseminating information and providing a forum for end-users to share their ideas and concerns about these important financial markets.

EUDA's overall objective is to encourage an efficient and liquid market for end-users for a variety of exchange-traded and over-the-counter (OTC) derivative products by taking actions to promote:

- Increased understanding of derivatives and their use;
- Reduced legal and other risks for end-users of derivative products; and
- Development of a legal and regulatory environment which is conducive to the appropriate and prudent use of derivatives.

EUDA's members have long recognized the value and importance of derivatives. In a worldwide economy, where the volatility of interest rates, currency exchange rates, and commodity and equity prices pose significant risks for a wide variety of business entities, derivatives have become essential risk management and investment tools. For many financial institutions and other types of corporations, the prudent use of derivatives offers a cost-effective means to manage those financial risks, which can have a material effect on their balance sheets, income and cash flows. Investment managers properly use derivatives to manage portfolio diversification, duration, liquidity, and cash flows. In the absence of derivatives, these risk management activities would be more costly, and in some instances, would be impossible to undertake.

EUDA's activities have been principally focused on (i) improving end-user education and understanding of the derivatives markets, (ii) promoting end-user discussion of issues important to entities which employ exchange-traded futures and OTC derivative contracts, and (iii) advocating end-user interests and concerns. Accordingly, EUDA has addressed such matters as proposals by the Financial Accounting Standards Board for new accounting treatment of derivatives and efforts by the dealer community to address (via voluntary codes of conduct and by contract) the relationship between dealers and end-users in the OTC markets. EUDA has also testified before congressional committees on the subject of regulatory jurisdiction over the OTC derivative market.

EUDA's members recognize that while derivatives are an important tool in the management of financial risks, their use (or misuse) can also pose risks. Accordingly, EUDA has examined a number of the situations where the use of derivatives has resulted in unanticipated losses and has sought to further the discussion among end-users on how to curtail or eliminate such mishaps. In this regard, EUDA stays informed of the issues affecting the legal and regulatory environment related to derivatives.

As noted in the Concept Release, not all end-users possess the same level of sophistication. On the one hand, a growing number of end-users have internal systems along with highly trained staff that allows them to model OTC derivatives independent of the dealer community. On the other hand, there are still a large number of end-users that are less sophisticated and must rely more on the dealer community for information regarding the fair value and risks associated with OTC derivatives. There are also certain types of OTC derivative contracts that can only be priced effectively by dealers.

EUDA does not believe it is in the best interest of end-users to create more stringent rules for the OTC derivative market based on the sophistication level of the end-user. It has been the existing regulatory framework for derivative transactions that has allowed the substantial growth in their use by end-users. To apply more stringent standards of conduct based on the sophistication level of the end-user would impose a difficult burden on dealers. This burden would inject unnecessary additional costs into each OTC derivative transaction. It may also reduce the willingness of dealers to create new types of products that are needed by more sophisticated end-users. For these reasons, no new regulation of the OTC market appears to be warranted and in the absence of Congressional action the CFTC should continue to use its authority under Section 4(c)(1) of the CFA to exempt OTC derivative transactions.

But the needs of less sophisticated end-users still need to be addressed. Instead of creating a higher standard on dealers when dealing with less sophisticated end-users, EUDA supports the development of an alternative to the existing OTC derivatives market for less sophisticated end-users (hereinafter referred to as the "alternative facility"). The alternative facility would allow more end-users to access derivatives to assist them in managing risks. In addition, the alternative facility would allow smaller end-users to engage in derivative transactions on a more level playing field. Small end-users do not always have sufficient commercial clout to negotiate adequate legal and credit terms under which derivative transactions are conducted. The development of an alternative facility for less sophisticated end-users would provide a market where they could access risk management tools on terms that are more appropriate than what is currently available to them in the OTC market.

Although the alternative facility would not necessarily be able to provide less sophisticated end-users with all the custom tailored products available in the OTC market, it would meet an important part of the risk management needs of this large group of financial institutions and other corporations.

Question # 1.

In general, end-users have become more sophisticated in their risk management skills over the past few years. Part of this elevated focus on risk management is the result of more stringent oversight by banking and other industry regulators. Even for non-regulated end-users, isolated but high profile cases involving substantial losses have focused greater attention by risk management staff on the type of derivative products used by their entities. As a result of this focus, many of the large end-users have adopted stringent internal policies that prohibit their traders from buying many of the highly structured products unless they can independently model those structures.

But not all end-users are equally sophisticated. Smaller financial institutions have entered the OTC market in recent years. Although these institutions have a significant need to use interest rate and currency swaps, they do not have the trained staff or models to independently price the products. To compound this weakness, many of these entities, including a good number of community banks and smaller manufacturing companies, do not have the commercial clout to negotiate "ISDA Master Agreements" and "ISDA Credit Support Annex Agreements" with the dealer community that fully protect their interests. These institutions are faced with the dilemma of either agreeing to language that exposes them to additional legal and credit risks or not using these types of products to manage their financial risk. A "caveat emptor" environment is unlikely to facilitate the long-term growth and liquidity of the OTC derivatives market.

Question # 9.

Much of the legal uncertainty that currently exists in the swap market results from a combination of two factors: 1) attempts to craft exemptions from regulation under the Commodity Exchange Act (the "CEA") without first determining whether swaps are actually subject to regulation under the CEA, and 2) the legal prohibition against off-exchange transactions in futures that are not otherwise exempted. This leaves swaps that fall outside the scope of the existing exemptions (whether because of the terms of the exemptions themselves, or because of limitations on the Commission's authority to grant exemptions) in a state of legal uncertainty. A possible solution to this legal uncertainty would be either: 1) to determine unequivocally (by interpretation of current law or, if necessary, by legislative amendment) that swaps are not covered by the CEA, or 2) to provide (presumably by legislative amendment) that the prohibition against off-exchange transactions does not apply to swaps even if they are considered to be futures. Such an approach would eliminate the need for endless tinkering with the terms of the existing exemptions (see, e.g., Questions 8, 10, 11, 14 and 15) as the market continues to evolve.

EUDA endorses steps to ensure meaningful input from the end-user community to the President's Working Group and proposals to have this group address what changes, if any, should be made to the regulatory environment regarding the OTC derivative market. After thorough consideration of the recommendations generated by the Working Group, Congress should determine the appropriate regulatory environment for OTC derivatives. The goal of any regulatory action by any agency, not just the CFTC, in the interim should be limited to providing greater legal certainty and greater competitiveness.

Questions ## 30 - 32.

Although there is room for improvement in the process by which dealer/end-user relationships are defined, the OTC derivative market is and should be one in which both dealers and end-users are ready and willing to assume responsibility for their own activities. See, e.g., the Federal Financial Institutions Examination Council Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities, 63 Fed. Reg. 20191, 20194 (April 23, 1998) ("Irrespective of any responsibility, legal or otherwise, assumed by a dealer, counterparty, or financial advisor regarding

a transaction, the acquiring institution is ultimately responsible for the appropriate personnel understanding and managing the risks of the transaction.") Consequently, it would not seem appropriate to introduce regulatory protections as a way of encouraging or facilitating participation in the swap market by entities that otherwise may not be fully prepared to assume this responsibility.¹

However, there are some institutions that would benefit from the proper use of derivatives that cannot be expected to have the resources to be on a level playing field with the dealer community. These institutions would benefit from being able to transact business through an alternative facility where the legal and credit terms would be more appropriate. The trade-off for these benefits would be the absence of more sophisticated products. Each end-user could make the decision regarding which forum (either the OTC market or the alternative facility) is best for it to conduct its risk management business.²

Questions 33 – 41.

Clearing facilities could serve a role in standard products, such as plain vanilla commodity, equity, and interest rate swaps. These facilities would allow less sophisticated end-users to access products on terms that are more balanced between end-users and dealers. It would also allow for more operational efficiencies, which would be valuable to less sophisticated end-users. Central clearing facilities would most likely promote market growth as a result of these greater risk management efficiencies. However, it is unlikely that central clearing facilities would be useful to more sophisticated end-users that desire more sophisticated products.

¹ This is not to say that a federal agency should not retain antifraud enforcement powers over the OTC derivatives market (with the decision on which agency should possess this authority to be made by Congress). A determination that OTC derivatives are not subject to the CEA would leave a substantial portion of this multi-trillion dollar market beyond the scope of any federal regulatory scheme and subject only to the protections afforded by state law. We are aware of no state regulators that purport to have the resources and expertise necessary to monitor this market and to take action against fraudulent or manipulative practices.

² To the extent that the alternative facility is not established and the existing approach of exempting transactions between eligible participants is retained (see comment re: Question 9 above), it would seem appropriate to adopt open-ended, or at least more extensive, exemptions for transactions between sophisticated market participants. The concept of a "qualified institutional buyer" that the Securities and Exchange Commission has adopted in Rule 144A could serve as a useful model for such an approach. Under this approach, it would not necessarily be appropriate to have a single definition of "sophisticated investor" that would apply in all contexts. The distinction that the SEC has drawn between an "accredited investor" and a "qualified institutional buyer" would again seem to provide a useful model for a regulatory approach that would involve progressively fewer restrictions as the sophistication of the participants in a transaction increases.

Any steps that can be taken to reduce or eliminate regulatory impediments to the development of clearing facilities, MTEFs or any other arrangements that might promote increased liquidity and price transparency in the swap market should be pursued as promptly as possible. Many of the concerns that have been raised about the swap market could be addressed more efficiently by taking such steps than by devoting continued attention to the definition of "eligible participants" or to the regulation of sales practices and related matters.

Questions ## 44- 47.

Imposition of any type of registration requirement for either participants or transactions in the swap market would likely involve costs far exceeding any attendant benefits. Indeed, given the manner in which the swap market has developed, it is difficult to identify what the supposed benefits attendant upon registration might be.

For sophisticated end-users, the market appears to provide sufficient regulation. Sophisticated end-users will only enter into transactions with counterparties that meet their creditworthiness standards. However, for less sophisticated end-users, they may not have the ability to access creditworthy counterparties. The development of an alternative facility to the over-the-counter market could provide the less sophisticated end-user with the credit risk management it needs to enter into derivative transactions.

Question # 50.

Credit ratings, when combined with appropriate internal credit risk controls (such as the establishment of counterparty exposure limits) and the use of various forms of credit-enhancement arrangements, are helpful although not a guarantee of creditworthiness. This is perhaps the area in which the swap market has most successfully demonstrated its capacity for developing market-driven solutions without the need for regulatory intervention. Participants in the over-the-counter market that devote the requisite effort should be in a position to assess for themselves whether, and on what terms, they wish to do business, or continue doing business, with particular counterparties. It is not apparent that the imposition of additional capital or disclosure requirements would accomplish anything other than to increase the cost of doing business.

The development of an alternate facility to the over-the-counter market would provide adequate protections to those end-users that do not have the resources to monitor the creditworthiness of their counterparties.

Questions ## 51 – 55.

Many participants in the swap market are already subject to regulatory oversight involving internal control requirements or guidelines. See, e.g., the Federal Financial Institutions Examination Council Supervisory Policy Statement on Investment Securities and End-User

Jean A. Webb
September 9, 1998
Page 7

Derivatives Activities, 63 Fed. Reg. 20191 (April 23, 1998). Even for market participants that are not subject to such oversight, the mere fact of participation in the swap market does not provide an appropriate basis for imposing such requirements or guidelines.

Questions ## 56 – 68.

Based on the results of the General Accounting Office's recent study of sales practices for OTC derivatives, it does not appear at this time that the swap market has experienced problems concerning fraud or sales practice abuses to an extent sufficient to warrant regulatory intervention. There is a need for improvement in dealer/end-user relationships, which have been characterized of late by efforts on the part of the dealer community to define the terms of such relationships unilaterally. (See, e.g., the Principles and Practices for Wholesale Financial Market Transactions and the non-reliance provision developed by the International Swaps and Derivatives Association). However, for now, these issues would seem to be best addressed through ongoing discussions between the dealer and end-user communities. The most useful role that any regulatory body might play would be in facilitating such discussions.

Questions ## 69 – 70.

As with possible requirements involving registration or internal controls, the imposition of any type of additional record-keeping or reporting requirement for participants in the swap market would involve costs that would likely to outweigh any attendant benefits. Many participants in the swap market are already subject to such requirements imposed by their functional regulators, and for market participants that are not, the mere fact of participation in the swap market does not provide an appropriate basis for imposing such requirements.

Thank you again for the opportunity to comment on the CFTC's "Concept Release on Over-the-Counter Derivatives."

Sincerely,



Dana A. Yealy
Chairperson
Legal and Regulatory Committee