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# THE TREASURY DEPARTMENT'S ROLE IN REGULATING THE DERIVATIVES MARKETPLACE

*Roger L. Anderson**

WHEN I told my previous employers that I was going to Treasury to work on federal derivatives policy, one of them exclaimed, "Oh no, you are going to regulate the hell out of them!" It is important to recognize, however, that we have not just come in and tried to regulate the derivatives market. We have tried to look before we leap and to understand the effects of the actions we will take. I would like to talk this afternoon a little about Treasury's general philosophy toward derivatives and then focus on a specific issue relating to the regulation of derivatives.

Fair, efficient, and innovative markets are critical to the sustained growth of our economy, and derivatives are an important part of that. In prior experiences, I and many others at Treasury have used derivatives, and we know their value. The challenge both for us as regulators and for the marketplace is to allow market participants to use and realize that value, while at the same time recognizing and managing the risks of derivatives.

Treasury itself has little direct regulatory oversight. The Secretary is, however, the Chair of the President's Working Group on Financial Markets. I have distributed a copy of a report that the Working Group sent two weeks ago to Congressman John Dingell, responding to various questions he had asked on stock market volatility. We used the occasion to list the efforts of the Working Group to reduce systemic risk. A few months ago, Secretary Rubin was quoted on one of the Sunday morning shows as saying that we were working on appropriate responses to market volatility. This report summarizes those efforts.

I will not go through this report and the efforts in detail; instead, I will describe our emphases. We have focused our efforts in two areas: 1) Minimizing the chances of a systemic threat occurring; and 2) Reducing the effects of a systemic threat that does occur. For us, disclosure and understanding are the keys to the first effort. The more that financial participants themselves are aware of the risks, then the better they will be able to protect their own interests.

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That is the logic of the regulatory initiatives using firms' value-at-risk models to assess capital charges that Governor Phillips talked about. Market participants' information is better than regulators'; and a firm's incentive to protect against risk is at least as great as anyone else's. Using this market incentive to protect individual firms helps benefit all market participants by reducing overall risk to the system.

The Derivative Products Group has also been very useful. An individual from one of the firms participating in the DPG told me that the various firms had agreed on a standard of the information they would provide to the SEC and CFTC, and they then had to figure out how to live up to it. For the firms, that process itself was very useful. The information is also, of course, useful to the SEC and CFTC. Indeed, if we look at the headline cases of derivatives problems—Barings, Orange County, Daiwa, Sumitomo—they appear to be failures of risk management, where the entity itself was not sufficiently attuned to the risks it was running.

When I gave a talk on derivatives in municipal finance many years ago, one accountant told me he had identified a control problem in a client because there was only one person in the organization that understood the derivatives. It is not enough for one person or even one part of an organization to understand the risks of derivatives. The risks have to be understood and accepted by those responsible for setting risk levels. Moreover, it is not enough for traders to understand risks; those with oversight responsibility, be they a Board of Directors or a Board of Supervisors, must also understand them.

The second half of risk disclosure is outside a firm—to investors and counter parties. Investors and counter parties should have the opportunity to evaluate a firm's risk exposure and risk management. I will not comment on today's hot topic, FASB's proposed rules for the proper accounting for derivatives, other than to say that the Working Group, including Chairman Allan Greenspan, has long expressed support for improved accounting for and disclosure of derivatives.

The second major effort of the Working Group, to minimize the effect of a systemic threat, has several aspects. Perhaps the most effective project has been to enhance the exchange of information among both various markets and various regulators. Again, disclosure of information helps people assess and manage risks. Another aspect of this effort to minimize the effect of a systemic threat is a project to clarify close out and netting rights of financial contracts in bankruptcy and insolvency. We have been working on that for more than two years, and we are now close to having a proposal to send to Congress.

Moving from the general to the specific, I would like to talk about the Treasury Amendment. The Treasury Amendment is part of the Commodity Exchange Act ("the Act") and provides that transactions in government securities, foreign currency, and certain other instruments are excluded from the scope of the Act, unless such transac-

tions are conducted on a board of trade. Treasury convinced Congress to include the Treasury Amendment in the CEA in 1974, because there were, and are, very large, efficient, and useful over-the-counter markets in government securities and foreign currency, and we did not want any arguments about whether or not these markets were subject to the CEA.

The underlying problem is known as the "death penalty" in the CEA. The basic rule under the CEA is that futures contracts traded off of an exchange are illegal and therefore unenforceable. Until 1992, when the CFTC got some exemption authority, there was no relief from that death penalty. Since then, the CFTC has granted certain exemptions, but each of those exemptions has certain conditions attached to it. The rub comes in that there is no clear standard for what is and what is not a futures contract, so that someone who enters into an over-the-counter ("OTC") contract for what may or may not be a future is at risk as to whether or not that contract can be enforced. Obviously, a market is unable to function on that basis.

The purpose of the Treasury Amendment was to avoid that uncertainty for the OTC government securities and foreign exchange markets. Ever since 1986, however, we have been disagreeing with the CFTC over the meaning of the Treasury Amendment. One area of disagreement was whether or not unexercised options, as opposed to exercised options, were covered by the Treasury Amendment. The Supreme Court resolved that question in *Dunn v. CFTC*.[1] Another area of disagreement is whether there is a participant limitation in the Treasury Amendment. We see no basis in the statute for such a distinction, although, as a policy matter, we have proposed legislation that would give the CFTC clear authority to pursue foreign currency bucket shops. These are entities that sell fraudulent foreign currency options to unsophisticated retail customers, and we agree that the CFTC should have the authority to pursue these entities. We just do not see the authority currently. A third area of disagreement arises because "board of trade," in the unless clause of the Treasury Amendment, is also a vague term. Therefore, we see a lot of value in the efforts of the House and Senate Agriculture Committees to clarify what is and is not subject to the CEA.

I do not intend to emphasize Treasury's differences with the CFTC, because we agree on a number of points, including the need to give the CFTC clear authority to shut down foreign currency bucket shops. The devil, however, is in the details, and the current legislative effort seems bogged down in those details. We are committed to trying to resolve the differences. Treasury, as a regulator, has a unique advantage because we are also a market participant. The market for Treas-

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1. 117 S. Ct. 913, 916 (1997) (stating that the Court was not persuaded by the CFTC's argument to exempt futures contracts from the Treasury Amendment's jurisdiction).

ury securities is the deepest and most efficient capital market in the world. Treasury and the taxpayers get enormous benefits from that. Participants' faith in the fairness of the Treasury market is crucial, and we work very hard to ensure that fairness.

But we are also attuned to the costs of uncertainty and the costs of unnecessary regulation. Regulation can impose costs of compliance, and, if those costs are not compensated for by the benefits of compliance, then those costs can get passed on to Treasury and the taxpayers. Accordingly, in our regulation of the government securities market, we strive to craft our regulations to minimize the burdens such that the benefits outweigh the costs. It is that perspective we bring to the debate over the regulation of derivatives.