OPENING STATEMENT
OF
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U.S. SECURITIES AND EXCHANGE COMMISSION
AT THE OPEN COMMISSION MEETING OF
MAY 4, 1993

Over the past decade, with growing force, we have seen the creation of a wide range of new products called swaps or "over-the-counter derivatives." The largest such products are interest rate and currency swaps, each of which have been increasingly used by companies and financial institutions to manage their activities in a more predictable manner. Going well beyond traditional interest rate and currency swaps, the market has also developed equity market swaps, total return agreements, and other instruments that demonstrate the creativity of the financial marketplace.

Most of these products are entered into by parties directly, with customized financial terms. They are not standardized instruments of the type traded on an options exchange or futures exchange, but rather the result of a system of contracts that exhibits immense flexibility to develop "customized" instruments. Of course, as the regulator of options since 1934, the SEC has considerable experience in overseeing exchange traded derivatives. Indeed, the Chicago Board Options Exchange, which is overseen by the SEC, today trades the largest number of derivatives on equity securities in the world.

The most recent estimates by the International Swap Dealers Association suggest that the daily global cash flows of interest rate swaps are $650 million, and $1.9 billion for currency swap contracts. These are important volumes, though not nearly so immense as is suggested by statistics concerning notional amounts ranging in the trillions. However these positions are measured, the positions in swap contracts of all kinds entered into by U.S. broker-dealers in recent years have been very large, and rapidly growing. Thus, it is central to the role of the Securities and Exchange Commission in overseeing the financial condition of broker-dealers that we have an effective program for understanding the activities of firms in the derivatives arena.

The SEC's net capital rule for broker-dealers was developed long before swap contracts became an important part of the financial landscape. The rule has long focused on market risk, and instruments that involve credit risk have generally been subjected to a 100% charge as an unallowable item for computing net worth. This traditional approach has had the virtue of guaranteeing that in the event a securities firm becomes insolvent, its portfolio could be liquidated immediately. This approach allows us to make the customers of a firm whole out of a highly liquid portfolio of saleable instruments without taxpayer assistance. The general validity of this approach was demonstrated in the failure of Drexel Burnham, when the SEC was able to unwind a $28 billion portfolio and prevent any losses to either the public or the customers of

Drexel's brokerage unit. This ability to liquidate a securities firm, even a very large one, prevents any need to consider use of public safety nets to prevent the failure of a broker-dealer. By allowing failures to occur, market discipline of considerable force is created, and market discipline is inherently more effective than bureaucratic disciplines.

As well as the net capital rule of the SEC has worked in general, it has not formed an adequate basis for the treatment of swap contracts and other OTC derivatives. By forcing a complete write off of the value of any such contracts, the rule in effect has led to firms moving derivatives activities outside the regulated broker-dealer and into less regulated affiliates. Of course, this does not eliminate the risk of such financial contracts to the overall firm. Rather, it simply removes them from the scope of the net capital rule.

It may be that segregating the risk of derivative instruments from the entity where public customers have their accounts in some cases is a good idea. However, in other cases that may be counterproductive if the management capacity, oversight systems or liquidity reserves of a special purpose affiliate are less than the broker-dealer. Ideally, the decision of whether a firm should use a separate affiliate for swap activities or whether these activities should be conducted within the broker-dealer should be a business question for individual financial institutions. That decision should not be driven by the impact of the net capital rule if that is not necessary to encourage financial stability. Thus, the purpose of the request for comments that we are considering today is to develop the analytic and informational base for modifying the net capital rule to measure and take account of swap and other derivative exposures in a more effective and positive manner than our existing rule.

Thus, today is the beginning of what will be a difficult but important effort to create a better system for regulating trading in swap contracts by securities firms. It should not be a presumption of this process that such contracts need tighter regulation. In some respects, our ultimate action may be to reduce what today is an unrealistic capital burden applied to such instruments. In other respects, this effort should help the SEC pay more careful attention to new products that involve traditional problems repackaged in different forms.

As I like to think has always been our hallmark, the Commission will approach those issues on a careful and thoughtful basis, informed by what I hope will be a widespread and extensive comment from the securities industry, users of derivative products, portfolio managers and other interested persons.

Our action is in a way similar to the proposals announced yesterday by the Bank for International Settlements and its supervisory committee in revising the treatment under bank capital rules of swap instruments. I am sure that insurance supervisors are also considering the proper treatment of these financial instruments for purposes of their traditional regulation. Indeed, it is important to recognize that derivatives are not and will not be monopolized in a particular location such as a futures exchange, an options exchange or even a few financial institutions. For the future, these instruments are likely to grow and expand and come into far wider use than is true today. As that occurs, the oversight of traditional institutions like broker-dealers, banks and insurance companies must develop appropriate methodologies and analytical techniques for applying their existing safety and soundness oversight to what will be widely-used tools of commerce and finance for the future.

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