Born, Again A1

CFTC Chief Refuses To Take Back Seat In Derivatives Debate

Combative Regulator Seeks To Leverage a Big Role For Her Little Agency

An 'I Told You So' Moment

WSJ — 11/3/98

By MICHAEL SCHROEDER

Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON—The nation's top financial regulators wish Brooksley Born would just shut up.

For nearly a year, Ms. Born, chairman of the Commodity Futures Trading Commission, has been warning about the risk of unregulated over-the-counter derivatives—financial contracts used to hedge bets on the direction of such things as commodity prices, interest rates or the value of stocks or bonds. No less than Federal Reserve Chairman Alan Greenspan, Treasury Secretary Robert Rubin and Securities and Exchange Commission Chairman Arthur Levitt have tried to muzzle her, claiming threats of new oversight could unsettle markets and trigger lawsuits.

Then came September's near collapse of Long-Term Capital Management LP, the hedge fund whose huge exposure to derivatives threatened to rock already-shaky world financial markets. Suddenly, the maverick CFTC chairman looked less like a turf-conscious alarmist and more like a modern Cassandra.

Brooksley Born

The Long-Term Capital uproar has put Messrs. Greenspan, Rubin and Levitt—members, with Ms. Born, of the President's Working Group on Financial Markets—in an awkward spot. The group, which considers financial-policy issues, has shunned increased oversight of both hedge funds and over-the-counter derivatives. Now, the same Working Group agencies that so vigorously opposed a CFTC regulatory review have been ordered to conduct their own.

Congress, spurred by the Long-Term Capital debacle and by Ms. Born's warnings, is considering revamping a patchwork regulatory structure. No one agency has direct oversight of OTC derivatives, or hedge funds, the little-regulated private investment partnerships that wager huge sums in global markets in search of quick profits. And while the Fed, CFTC, SEC and Treasury each oversee parties to derivatives transactions, such as banks and investment firms, lawmakers may feel pressure to consolidate that responsibility.

Uphill Battle

Ms. Born's crusade has been to secure a significant piece of that regulatory action for the CFTC, regarded in Washington power circles as a second-rate overseer of agricultural commodities. It is one of the smallest federal agencies, with a $61 million-a-year budget and 580 employees, compared with the SEC's $336 million budget and 2,700 employees.

Ms. Born herself has hobbled her cause. Earlier this year, she exhibited striking political tone-deafness by resisting intense pressure to put off studying possible new derivatives regulation. She alienated fellow regulators, the chairmen of the Senate and House agriculture committees, which oversee the CFTC, and most of her own agency's commissioners. Even with the Long-Term Capital calamity to point to, she could still wind up a loser.

"Yes, I've caused myself a lot of grief, but that's what a life acting on principle is all about," Ms. Born says in an interview.

Her small stature and polite manner belie a cool conviction under fire. "She's an idealist—some would say ideologue—who is quite stubborn in pursuing her vision," says Susan Ervin, a former CFTC senior counsel.

A Litigator's Style

Ms. Born, 58 years old, honed her combative style over 31 years as a litigator at the Washington law firm Arnold & Porter, specializing in complex regulatory cases involving commodities, securities and international trade. She is a longtime friend of first lady Hillary Clinton, through their committee work for the American Bar Association. Before President Clinton appointed her to the CFTC in 1996, Ms. Born was on the short-list for attorney general.

But none of that could have prepared her to stand up to Washington's mightiest regulators and the Wall Street interests complaining about her calls for closer scrutiny.

The CFTC regulates futures and options traded on exchanges, but not derivatives traded privately over the counter between financial institutions or corporations. With names like swaps, puts, collars and swaptions, such derivatives now have a notional—or principal—value of nearly $30 trillion. These vehicles can be regulatory nightmares because they aren't disclosed on balance sheets, and their complexity makes monitoring them nearly impossible. They are even tougher to follow when they fill the portfolio of hedge funds.

Long-Term Capital's problems offered Ms. Born a delicious opportunity to tell her critics, "I told you so." For the first time, a massively leveraged hedge fund had posed a risk not just to investors, but also to the financial system. Regulators worried that if Long-Term Capital defaulted on its risky derivatives contracts, it could cause a

Please Turn to Page A8, Column 1

124

CFTC Chief Presses Her Case in Debate on Derivatives

Continued From First Page

chain reaction, bringing down other institutions and roiling financial markets. Concern ran so high that the Federal Reserve Bank of New York brokered a $3.63 billion investor bailout to keep the fund afloat.

As congressional hearings approached in October, Ms. Born circulated a list of talking points to key lawmakers, warning that the Long-Term Capital situation was good reason for her agency not to be stifled or shunted aside. "Swift regulatory responses may well be needed," she told lawmakers at an Oct. 1 hearing.

She and her staff were elated when lawmakers complimented her on her foresight. "Doesn't this lend some credibility [to the CFTC's stance], or at least the concept of some regulator looking at the entities?" asked Rep. Bruce Vento, a Minnesota Democrat. In a staff meeting the following week, Ms. Born gloated about bringing some lawmakers around to her view, says a person with knowledge of the meeting. Ms. Born declines to comment.

The vindication was sweet because Ms. Born had endured months of political pummeling for insisting that unregulated OTC markets required fresh scrutiny. Her problems began after the SEC proposed late last year to scale back regulation of derivatives dealers to encourage Wall Street firms to sell the investments through their U.S. broker-dealer operations, rather than via foreign units.

The CFTC, led by Ms. Born, protested that the SEC proposal, which the securities regulator approved Oct. 21, was a thinly veiled attempt to steal the CFTC's jurisdiction over some financial derivatives. Her agency countered by proposing a study to determine if the CFTC should impose new rules on the OTC market.

The move ran against the views of the president's high-powered Working Group. In 1994, after a government-securities trading scandal and major corporate derivatives losses, the General Accounting Office proposed expanded regulation of the OTC markets. The Working Group concluded that no new oversight was needed.

Ms. Born, in proposing the CFTC study, argued that the agency had the legal right to regulate derivatives and, at the very least, could consider revising rules. But the Treasury, Fed and SEC insisted she had misread the law and that the CFTC had no such authority. Those agencies were hearing pointed complaints from Wall Street, which worried that Ms. Born's plan was already disrupting markets and fomenting fears that some investors would sue to get out of money-losing transactions, arguing that they should have been regulated.

The disagreement came to a head in April, at a meeting in the Treasury secretary's ornate, high-ceilinged conference room. Messrs. Greenspan, Rubin and Levitt tried to discourage Ms. Born from going forward with the review.

After some spirited debate, an exasperated Mr. Rubin asked Ms. Born why she wouldn't change her mind when her three counterparts were squarely against her. She replied by reiterating her position in her characteristically deliberate style. "She didn't give an inch," one participant says.

Nevertheless, Messrs. Greenspan, Rubin and Levitt left the meeting thinking the CFTC had agreed to put off its study until a new committee, headed by the Treasury's general counsel, considered whether such a study was needed. The CFTC made available a draft of its plan for conducting a study to Working Group staffers in a conference room at CFTC headquarters in late April. To avoid leaks, they weren't permitted to make photocopies of the document.

But on May 7, the CFTC made its draft plan public. Ms. Born says the news release shouldn't have come as a surprise because she never "gave assurances that we would not move forward." However, the other Working Group members were furious, as were congressional leaders. Messrs. Greenspan, Rubin and Levitt co-signed a terse letter to Congress pledging to propose legislation that would halt the CFTC study. Richard Lugar, the Indiana Republican who is chairman of the Senate Agriculture Committee, wrote a letter urging Ms. Born to "avoid any unnecessary interference in these productive and healthy markets."

House Banking Chairman Jim Leach, an Iowa Republican, offered a compromise under which the CFTC would hold off recommending any new rules until Congress and the Working Group could review the issue next year. No dice, Ms. Born said. In a meeting with Ms. Born and other regulators, the normally mild-mannered Mr. Leach grew agitated when Ms. Born repeatedly rejected his offer, saying she couldn't commit to such a compromise without approval of the five-member CFTC.

In fact, three other CFTC commissioners favored postponing the study, but they didn't get a chance to vote. Commissioner Barbara Holum, a Democrat, says she asked Ms. Born to poll commissioners, but was rebuffed. Ms. Born says Ms. Holum asked for a vote on "a position that expressed [Ms. Holum's] view," but no other commissioners requested a vote.

Finally, Ms. Holum and Republican Commissioners James Newsome and David Spears took matters into their own hands, writing Sen. Lugar in support of a moratorium on a CFTC study. Before it recessed last month, Congress approved a six-month moratorium as part of an omnibus budget bill, signed by Mr. Clinton.

So strained are Ms. Born's relations with her fellow commissioners that she didn't solicit their approval of her prepared remarks before she testified at the House Banking Committee's Oct. 1 hearing on Long-Term Capital. Ms. Born says she didn't have time to do so and, anyway, she was asked to testify as an individual commissioner. Ms. Holum says it was unprecedented for a CFTC chairman to represent only herself before Congress.

In part, Ms. Born is fighting for the future of her agency, which comes up for reauthorization by Congress next spring. "She's playing to win—or lose," says a Working Group participant. "If she loses, the agency could lose some funding and responsibilities, or it could be merged" with the SEC.

Given the Working Group's preference for the status quo, the OTC markets aren't likely to see wholesale new policing. Even Ms. Born isn't likely to support wide-ranging reform. She says she now believes that more reporting on derivatives positions is necessary, and she would like to see better coordination among regulators world-wide. She would also like Congress to confirm that her agency has a role in regulating derivatives.

Yet, despite the Long-Term Capital situation, Ms. Born's Working Group colleagues are likely to recommend that the CFTC be stripped of some authority. The Fed's Mr. Greenspan has said it would be counterproductive to impose new oversight, arguing that hedge funds' sophisticated investors and lenders already provide plenty of oversight in the interest of protecting their investments.

The SEC's Mr. Levitt also is skeptical about more regulation, but does favor more disclosure. Treasury has raised questions about whether hedge funds should be regulated in some respect, although Mr. Rubin has privately told colleagues that he fears derivatives could rattle the markets.

The Working Group has been ordered to present separate preliminary study findings to Rep. Leach by Feb. 1 and to Sen. Lugar by March 1. The scope of the inquiries has yet to be determined, and the participants are discussing what role—if any—the CFTC will play. Many observers think the group will recommend that authority over OTC derivatives be shifted chiefly to the Fed, which could then more aggressively monitor banks in the derivatives business.

With her term expiring in April, Ms. Born's future as a regulator is in doubt. While her overseers in Congress haven't embraced the idea of a second term for Ms. Born, she says she hasn't yet thought about seeking reappointment.

1325