SEC, Six Firms Work to Set Derivatives Rules

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The Securities and Exchange Commission is negotiating with six of the nation's biggest securities firms in an effort to set voluntary standards on the most hotly contested aspects of their derivatives sales and trading businesses.

The negotiations, which represent unusual cooperation among traditional adversaries, are the first attempt at formal oversight of the derivatives activities of Wall Street firms. Currently, securities firms' derivatives activities are not regulated. People on Wall Street familiar with the talks say any regulatory standards that evolve would be voluntary because the SEC lacks formal jurisdiction to oversee units that are not broker-dealers.

An agreement between the SEC and Wall Street may possibly head off congressional critics now calling for strict controls of derivatives, which are financial arrangements whose values are linked to stocks, bonds or currencies. The General Accounting Office, the Congress' watchdog agency, warned in a recent study that the lack of regulation could create a systemwide financial problem.

"We're hoping to come up with something by fall . . . the kind of oversight that might diminish the need for legislation," SEC Chairman Arthur Levitt said in an interview. "It's my feeling that the kind of agreement we and the firms could reach together would be better than the kind of rules we might have to force on them, or that Congress might have to mandate."

People in the derivatives industry say a compromise would be good news if one can be reached. "It's a more proactive position to be taking," said Paul Gottlieb, a partner specializing in derivatives at Seward & Kissel, a New York law firm. "I hope it's not too little too late."

Regulatory Legislation Planned

Indeed, Rep. Edward J. Markey (D., Mass.), chairman of the House subcommittee on telecommunications, is planning legislation that would require the SEC to regulate the derivatives businesses run by securities firms and insurance companies. Currently the only dealers that are regulated are banking companies. In a statement yesterday, Rep. Markey said "legislative reforms will be needed if we are to close the regulatory black hole, which currently allows derivatives dealers affiliated with securities or insurance firms to largely escape any federal regulation."

The market in derivatives instruments is expanding rapidly in the U.S. and abroad as companies seek ways to better manage financial risks—or a cheap way to make bets in the financial markets. While derivatives are intended to help these corporate users reduce their financial risks, some multimillion-dollar derivatives-related losses at companies such as **Procter & Gamble Co.** and **Metallgesellschaft AG** have demonstrated that the instruments can create big risks of their own. As incidences of losses increase, so do calls for increased federal regulation and control.

Market Share Growing

Heavily regulated banks control about 70% of the U.S. off-exchange derivatives business. Securities firms and three insurance companies account for the rest, but their share of the market is growing at a faster rate than that of bank dealers, according to the GAO.

Derivatives Exposures

Exposure of Wall Street derivatives dealers, in billions, as of year-end 1993

	NOTIONAL PRINCIPAL AMOUNT	REPLACEMENT COST
CS First Boston	$1,187	N.A.
Goldman, Sachs[1]	1,029	N.A.
Lehman Brothers Holdings	844	$3.4
Merrill Lynch	891	7.4
Morgan, Stanley[2]	629	5.0
Salomon Brothers	999	8.6

N.A.= Not available
[1]As of Nov. 26, 1993 [2]As of Jan. 31, 1994
Source: Company reports

People in the SEC's market-regulation division, including division chief Brandon Becker, are negotiating with executives of the six firms that dominate Wall Street's derivatives business: **CS First Boston** Inc., **Goldman, Sachs** & Co., **Salomon Brothers** Inc., **Merrill Lynch** & Co., **Lehman Brothers Holdings** Inc. and **Morgan, Stanley** & Co. The talks began after Mr. Levitt phoned the chief executives of the six firms and asked for their cooperation.

The SEC wants to set concrete standards for the three most contentious issues involving derivatives: what firms must disclose about their highly secretive derivatives operations; how much capital they must have on hand to back their trades; and the suitability of peddling derivatives to users such as cities, pension funds and mutual funds, in which unsophisticated investors have financial stakes.

Setting Their Own Standards

Until now, Wall Street firms have, for the most part, set their own standards in all these areas. The current talks, the SEC's Mr. Becker said in an interview, are intended to "strengthen the information base for our risk-assessment program, develop better methods for evaluating capital adequacy and ensure that customer-protection issues are appropriately addressed."

Mr. Levitt of the SEC favors establishing a common clearing house to guarantee trades in the off-exchange derivatives market, as clearing houses now back exchange-traded derivatives such as futures and options contracts, people familiar with the talks said.

Wall Street executives are cool to that idea, since they would probably have to pay costs associated with any clearing house. Moreover, a clearing house would tend to dilute any competitive edge one firm enjoyed over another.

"I think at the end of the day, once the risks have been fleshed out and quantified, everybody will end up agreeing we all have more than enough capital for the risks that we're running," said Zachary Snow, a managing director at Salomon Brothers and chairman of the Securities Industry Association's off-exchange derivatives committee.

Wall Street executives argue that the public markets are better regulators than federal lawyers and bank examiners, and defends the autonomy by pointing to stringent requirements for obtaining triple-A ratings at firms' derivatives subsidiaries.

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These are wholly owned units exclusively devoted to making markets in derivatives; the higher the credit rating, the more comfortable their clients and other dealers are in doing business with them.

International Cooperation

People on Wall Street familiar with the SEC talks describe them as a way to accommodate Washington without stifling their own derivatives businesses. One possible outcome is having the securities firms abide by new capital rules that are being imposed on big international banks. Last year, the Bank for International Settlements proposed new capital standards for market risks – that is, risks from fluctuating currencies, interest rates and derivatives. As one step toward exploring whether securities firms hold enough capital to support their huge derivatives trades, SEC staff members are asking Wall Street firms to compare their exposures to these pending international standards.

Mr. Levitt said he also intends to press for cooperation from regulators abroad. "We want an international netting agreement and bankruptcy laws that would take into account the international nature of this business," he said. He said securities regulators in Britain and Japan have agreed to talk with SEC staff about these matters.

People involved in the talks said they are being conducted through a series of "working groups," in which designated staff from the SEC and firms meet in New York to debate and discuss the capital, disclosure and suitability issues. "Most difficult of all is suitability – how you arrive at a standard that applies equally to pension funds, municipalities and dealers," Mr. Levitt said.