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Swaps in Danger

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Back in the early 1990s a Washington regulator named Wendy Gramm voluntarily curtailed her own agency's power. In a campaign that involved corralling Congressional support, Ms. Gramm argued for and won a narrow definition of the term "futures" that excluded hedges known as swaps. It was an unusual step in a city where agencies amass power. How unusual we are learning only as Ms. Gramm's successor at the Commodities Futures Trading Commission, Mary Schapiro, tightens the screws on the swaps market.

Swaps are tailored contracts that allow companies to shed risks on variables like interest rates, commodity prices or exchange rates. McDonald's uses them to screen out currency risk when it opens shop in Shanghai. Atlanta's public transit system, MARTA, used them to hedge against fuel price spikes at the time of the Gulf War. Smaller companies also find them an economical way to hedge against change. The internationalization of business and the end of fixed exchange rates has driven the value of goods and services covered by swaps and related transactions to $11.3 trillion. Two agencies—the SEC and the CFTC—regulate derivatives traded on exchanges and the institutions that deal in them. No federal agency, at least until now, regulates the privately negotiated contract known as the swap.

Ms. Schapiro has insisted that her agency is not going after swaps. But as Merton Miller and Christopher Culp document in the columns nearby, Ms. Schapiro's agency recently proceeded to adopt a markedly expansive interpretation of the meaning of "futures" in its evaluation of Metallgesellschaft's derivatives debacle. It also spooked the swaps market by slapping the company with a $2.25 million civil penalty.

To understand what kind of signal the CFTC's rendering on Metallgesellschaft's U.S. subsidiaries sends, it helps to review the case. The German multinational made bad investments in derivatives; the market punished it with almost $2 billion in losses. *Then* the CFTC added insult to injury with the fine.

At least three aspects of the CFTC's July 27 order were particularly aggressive. The first was the CFTC ruling that Metallgesellschaft swaps were actually "illegal off-exchange futures contracts." At issue were 45-day agreements to deliver fuel. The agreements were of a kind the marketplace had heretofore classed as outside the CFTC's reach; Ms. Schapiro's team said they "contain all the essential elements of a futures contract." It was language vague enough to jeopardize swaps.

The second shift was that the CFTC fined Metallgesellschaft for problems like "material inadequacies in internal control systems." Traditionally the CFTC has looked for fraud; this time, it alleged none. The new order appears to show that the CFTC now feels it can punish the company for bad management and taking risks. A speech Ms. Schapiro delivered at the ABA subsequent to the MG Enforcement Order took MG to task for operating under an "unreasonable assumption"; she seemed to be saying we ought to make bad management a federal offense.

Most disconcerting was the CFTC ruling that some of MG's contracts were "illegal and therefore void." Companies who had contracted with MG then received letters from the firm stating that the CFTC Enforcement Order meant it would no longer have to fulfill its obligations. Those companies weren't all giants: Three independent gas and diesel merchants are in court with Metallgesellschaft.

The Metallgesellschaft decision has already had a chilling effect; dealers at the big Wall Street houses who write the swaps contracts report a falloff. Typical of the newly cool environment were remarks of CFTC general counsel Elisse B. Walter, reported in the trade paper Oil Price Information Service. To firms concerned about whether they might be making the same mistake as Metallgesellschaft, she gave the following advice: "If you have deals that might be similar [to the MG contracts] give us a call and talk to us." Sure.

Historically the SEC was the lawyer-enforcer. The CFTC by contrast was a Chicago-inspired agency dominated by free-market economists and a trader spirit. Wendy Gramm, Ms. Schapiro's predecessor, is an economist. She made it her mission to keep CFTC paws out of swaps. Ms. Schapiro by contrast is a trial lawyer from the SEC.

The losers here go beyond the Beltway and big players like Metallgesellschaft. Three of the companies whose contracts were "voided" are A.T. Williams of Winston-Salem, N.C.; Knight Enterprise of Novi, Mich.; and R.C. Jordan Oil of Spartanburg, S.C.—in short, Main Street, America.

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