Withdrawal/Redaction Sheet
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. note	[From Ellen S. re: Lugar's Proposal...] (1 page)	n.d.	P5
002. handwritten notes	[re: Current Law...] (3 pages)	n.d.	P5

COLLECTION:

Clinton Presidential Records
Council of Economic Advisers
Jason Seligman
OA/Box Number: 23924

FOLDER TITLE:

Financial Mkts Work Group (2)-CFTC/Treasury Amendment

2010-0673-F
pr5

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

- P1 National Security Classified Information [(a)(1) of the PRA]
- P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
- P3 Release would violate a Federal statute [(a)(3) of the PRA]
- P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
- P5 Release would disclose confidential advice between the President and his advisors, or between such advisors [a)(5) of the PRA]
- P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

- b(1) National security classified information [(b)(1) of the FOIA]
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EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS

Ellen S.:

Lugar's Proposal about professional accounts. Guy from Merk is a big supporter.

We prob. have about a wk.

If we say Merk has a good case (or strongly not) he might act.

Lisser is cap. of banks.

Get Treasury ~~[illegible]~~ view.

3 elements

1. Does allowing this legislatively make sense economically? (excessive fraud?)
2. Loose critical mass & ruin retail exchanges?
3. Effect on competitive ~~[illegible]~~ position of banks?

Current Law: (1974, Commodity Exchange Act)

- CFTC has jurisdiction over futures + options
- "Treasury Amendment" exempted off-exchange derivatives transactions ("Treasury Amendment") in gov. securities, foreign exchange, & other exempt (?) financial instruments. in Treas. prop. → (Resales of installment loans, mortgages & mortgage purchase commitments.)
- Problem: CFTC may view some transactions as non-exempt which are, or should be, exempt.

Treasury proposal:

1. Exempt all transactions in any way involving gov. securities unless they are conducted on an organized exchange.
   Note: Retail transactions are already covered by federal securities laws.

2. Foreign exchange transactions.
   - CFTC would have anti-fraud authority in transactions between unregulated "persons" and retail customers.
   - CFTC would have no authority in transactions between regulated "persons" (U.S. brokers + dealers, banks) and retail customers. The regulators of the regulated persons (Fed, OCC, SEC) would regulate such transactions.
   - CFTC would have no authority in transactions between those who are not retail customers (whether they are regulated or unregulated)

3. Definition of "Organized Exchange"
   - Treasury def^n makes it clear that banks, broker-dealers, etc. are not "organized exchanges."
   - exchanges are entities that serve as a marketplace for arms' length transactions.
   - Cannot be a org. exchange if not open to retail customers. (allows unregulated markets for institutional customers).

CFTC proposal:

From letter

1. Retain CFTC jurisdiction over
    a. ~~[illegible]~~ Retail transactions
    b. transactions on organized exchanges.
2. Exempt otc futures + options trading in f/x + gov. securities among institutional firms + "appropriate persons."
3. Ensure that the fed. gov. has authority to prevent fraud + manipulation in futures + options transactions that are otherwise exempt.

---

1. Sales to Retail customers.
    - covered by "full scope of CEA regulatory protections" (including those of Treasury amendment instruments.) CFTC argues that fraud powers alone are not sufficient.) (Also that even financial institutions shouldn't be exempt.)

2. Transactions on exchanges — still covered by CEA.

3. "Appropriate persons"
    - OTC futures + options between appropriate persons would be exempt from CEA's regulatory provisions.
    - "Ap. persons" defined in CEA to include fin. institutions, those regulated by CFTC or SEC + others as determined by the CFTC.
    - Such traders would still be covered by the anti-fraud + anti-manipulation prohibitions.

4. Fraud + Manipulation Prohibitions
    - Enforcement authority for fraud + manipulation in O-TC T-A transactions between "app. persons" would be maintained.
        - Could be via CFTC, SEC, or fed. banking regulators. (gov. securities(?)) (banks.)
        - CFTC notes that damage caused by fraud + manipulation has costs potentially larger than those to particip[ants].

	Exchange	OTC non T-A	OTC T-A
Retail	✓	✓	CFTC: ✓ Treas.: Fraud only. In case of gov. sec's, by SEC. In case of banks, by bank regulators. For other reg. firms their regulator.
~~wholesale~~	~~✓~~	~~✓~~	
Wholesale	✓	✓	CFTC: Fraud + manipulation only. – by CFTC only when not by other Fed. regulator Treasury: not covered.

Withdrawal/Redaction Sheet
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. note	CFTC concept release; RE: Phone number [partial] (1 page)	n.d.	P6/b(6)
002. handwritten notes	re: Financial Markets Working Group Principals Meeting (9 pages)	04/21/1998	P5

COLLECTION:

Clinton Presidential Records
Council of Economic Advisers
Jason Seligman
OA/Box Number: 23925

FOLDER TITLE:

Working Group on Financial Markets (July 1997 - November 1998) [Binder] [1]

Debbie Bush
2010-0673-F
db2067

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

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Financial markets working group 21/iv/98
principals' meeting

(1) Collars and sidecars:

(B. Born opened): Rule 80A should be abolished, or at least, trigger points should be raised. (Disconnect futures mkt. from stock mkt.)

Grasso (NYSE): Will ↑ trigger to 90 points.

→ Born ~~[illegible]~~ proposed that SEC send message to NYSE to abolish.

→ Levitt (SEC) ~~[illegible]~~ agreed ✓

→ Greenspan: What is effect on stabilizing mkt.?

→ Born: none. Just seems to slow down index arbitrage.

→ Greenspan: NYSE must have a reason ~~f~~ for those... why does Exchange support?

→ Born: specialists like; futures mkt. view this as a competitiveness issue.

→ Greenspan: Important to understand their motives.

// Primary beneficiaries: specialists. (who need to slow orders)

→ Greenspan: If specialists changed view, would Grasso?

→ Levitt: yes, w/o question.

→ Rubin: Has given no thought to the issue.

Levitt: Letter under wkg. group's cover would be best...

Rubin: Would upstairs firms be in favour? // Levitt: Yes.

So, SEC will draft a working group letter in ~~[illegible]~~ favour of ~~[illegible]~~ recalibration or repeal... This will be sent around.

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(2) CFTC concept release:

Born opened: ~~the~~ CFTC is engaged in overall regulatory reform project.
Currently ~ a dozen concept releases / proposed rule changes

OTC derivatives: CFTC proposes concept release re. whether current exemptions & regulations for OTC derivatives are appropriate.

Issues: CFTC adopted exemptions of swaps & hybrids ~ 1993. These are narrow exemptions (fraud, &c); parts of CEA are applicable.

Swaps exemption: bilateral, customized transactions betw. ~~soph~~ sophisticated parties.

Hybrids exemptions: for instruments that are mainly securities.

→ For swaps: · Must not be fungible .. now, come close
· Clearing ~~for~~ forbidden. Many requests to permit clearing & exch. trading.

CFTC criticized for maintaing fraud & manipulation authority w/o having tools (recordkeeping, disclosure) to make this enforceable.

Other regulators have stepped in ...

CFTC asks:

- Does CFTC need to change current reg. regime?
[wants to avoid duplication].

CFTC feels that they must go forward given how marketplace has evolved... Part of CFTC statutory mandate. Two options face CFTC:

① Take enforcement action for those in violation of regs as they currently stand

② Rationalise current reg.s.

- ② is preferable, in CFTC's view, as well as in Born's view.

- No need for CFTC to explicitly assert ~~g~~ breadth of jurisdiction in concept release — unless challenged.

- One problem w/ asserting jurisdiction: equity swaps.

<u>Equity swaps</u>: CFTC exemptive authority doesn't cover equity swaps.

→ No interest in dealing w/ Treasury Amendment issues; not in CFTC's jurisdiction.

$\boxed{\text{Comments:}}$

<u>Greenspan</u>: Fungibility & notion that plain vanilla swaps are ~fungible and indistinguishable from exchange-traded options.

Fungibility: In context of contract, certain aspects of contract specify def.n of price involved, grades, &c., clearing house as counterparty.

How, then, can plain vanilla swaps be fungible given that condition that exchange be counterparty is <u>violated</u>?!? Counterparties are <u>not</u> <u>substitutable</u> in swaps...

Born: "Fungibility" is defined in rules & regulations... (term fungible is in statute; but is defined by rules).

Greenspan: Economics should inform these def:s...

If def: is as Born has said, shouldn't rules be changed?

Born: Since 1922, all ~~ex~~ exchange instruments forbidden & — except as CFTC exempts — (after 1992/3).

Being asked to allow for clearing & exchange trading, so...

Greenspan: granted, but issue is that regulation should enhance development of financial institutions... OTC derivatives have made an important contribution... Regulation, &c. might suppress OTC derivatives business — & only benefit would be a cleaner law/regulatory structure...

OTC deriv.s have outpaced exchange deriv.s ∵ of customised nature of counterparties...

Born: CFTC doesn't want to suppress; wants to encourage by giving greater legal certainty. Don't want to

Rubin: Implicit in concept release: CFTC has jurisdiction.

Financial community "petrified" that conc. release ⇒ that swaps are futures... Those on losing end can then ~~litigate~~. see litigation opportunity.

Raises uncertainty over trillions of ~~$~~ dollars of transactions

COPY

So- key is to find neutral way to put out concept release:
Congressional committee or

→ Treasury will put out statement that CFTC has no
jurisdiction if CFTC goes forward.

<u>Born:</u> Why should ~~[illegible]~~ looking at ~~[illegible]~~ CFTC's own regs. cause
uncertainty?
→ Already regulate nonexempt OTC deriv.s ~~[illegible]~~ ..
→ Authority retained by CFTC ...

<u>Rubin:</u> Massive concern.
<u>Born:</u> They might not know what is
~~[illegible]~~ CFTC <u>has</u> ~~[illegible]~~ jurisdiction over nonexempt swaps that are
~~Rubin~~: really futures & options.

<u>Hawke:</u> Just making concept release raises issue of ~~[illegible]~~
regulatory authority...
Implicit in concept release: Are swaps options/futures?

<u>Levitt:</u> Issuing concept release w/ exceptions taken by Fed, SEC,
and Treasury is problematic.
<u>Better ways</u> to air issue.

<u>Born:</u> Groups that have seen her are only concerned that conc. release
not explicitly determine whether swaps are futures or options.

Summers: Given that, rightly or wrongly, Treasury, Fed, SEC, & industry view concept release as being disastrous for market, is there not a better way to proceed? (so that CFTC isn't odd man out...).

So, what is best

Rubin: Chairman of Senate Ag. Committee is also against, and wants wkg.-group f

(Rubin: more concerned w/ derivatives)

Born: Angry ~~Pissed~~ about "breach of confidentiality" of wkg. group.

(*) (CONCEPT RELEASE was LEAKED!) by Treasury? (*)

(Supposedly Dept. of Treasury ~~as~~ insisted Lugar ~~to~~ send letter — ?)

Rubin:
- Doesn't disagree w/ substance of CFTC's actions
- Thinks there is a better way to proceed.

Born: Rubin is asking CFTC not to uphold the law

Rubin: Great uncertainty over law as it applies...

Greenspan: ~~As~~ Decades ago, anomaly in reg.s created Eurodollar market ... Despite later Δ to regulation, mkt. continued in London -- Worry, then, that OTC derivatives market could flee to London (or Europe) if this isn't handled well. That would be a failure on CFTC's part.

Rubin: Not suggesting CFTC not attain goal - but rather that CFTC find better approach toward attaining goal — one that does not carry such risks...

Legal staffs of various agencies should get together.

Knight: What is source of illegality?

Born: Requests from various groups to have clearing of [equity] swaps — CFTC on record as open to reinterpreting clearing of swaps... need to address requests to consider swaps clearing...

Levitt: Haven't courts found that CFTC has no jurisdiction over equity swaps clearing?

Born: No.

Parkinson: one can read jurisdiction differently; hence uncertainty. Stating where illegality lies is scary — : noone has ever thought that plain vanilla swaps might possibly be not subject to the exemption —

Hawke: A lot of the "questions" involve areas that are quite akin to regulation (capital requirements, e.g.). why upset the apple cart?

Greenspan: 1992 hearings had consensus: not to deal with this issue (avert eyes & let it continue).

[Born:
~~Cohen Bond~~ Deriv.s a concern in 1930s!]

Rubin: need to ~~fig~~ figure out process for legal staffs to get together.

Greenspan: Can't "put ~~cork~~ cork back in bottle" — once ~~table~~ we begin ~~or~~ process, has possibility of serious uncertainty...

There are contradictions in the CEA — but that shouldn't ~~induce~~ induce us to do things that will undercut the ~~sys~~ system that we are beholden to serve...

Rubin: Need to get ~~council~~ counsel of various agencies together & then meet on this later...

Born: Alright.

Year 2000: (see handout).

U.S. system in good shape, but international system (banks & exchanges) are in trouble.

Greenspan: Regulators cannot ~~~~ guarantee that this extremely complicated issue is in hand...

→ Regulators cannot assume responsibility ...

→ Yardeni has absolutely no analytical basis for his prediction that Year 2000 will cause a recession...

Sally Katzen: Working w/ CEA on this...

Withdrawal/Redaction Sheet
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	Sarah Rosen to Ingrid M. Schroeder et al. re: Treasury Testimony on CFTC (2 pages)	06/08/1998	P5

COLLECTION:

Clinton Presidential Records
Council of Economic Advisers
Jason Seligman
OA/Box Number: 23925

FOLDER TITLE:

Working Group on Financial Markets (July 1997 - November 1998) [Binder] [2]

2010-0673-F
pr6

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
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Sarah Rosen
06/08/98 08:50:21 PM

Record Type: Record

To: See the distribution list at the bottom of this message

cc: Sally Katzen/OPD/EOP, Shannon Mason/OPD/EOP, Roger S. Ballentine/WHO/EOP
Subject: Treasury Testimony on CFTC

(1) The not-so-subtle reference to merger of the CFTC and SEC (next to last sentence -- "Congress may wish to consider whether there may be a structural flaw in the US regulatory regime .... causing unproductive legal confusion and conflict to erupt with disturbing regularity) should be deleted! That isn't administration policy and has not been vetted. This is a code that will be understood by all participants. THIS IS THE MOST IMPORTANT CHANGE.

(2) Nowhere does the testimony explain why it is important for the nation or its citizens to have an active OTC derivatives market. The best try, middle paragraph, p.2, simply asserts that disruption inhibits use of a risk management tool and has global implications. Why should an american citizen care? Who are the users of these instruments that would be harmed by limiting the market? This isn't compelling as a public policy issue. Without better justification, just sounds like Treasury wants to protect the traders from regulation.

(3) The last sentence, 4th paragraph, page 2 appears to be missing a word: "reducing the ability of US businesses [TO DO WHAT?] and inhibiting the growth of these activities at US institutions." Moreover, again, why as a matter of public policy do we care if business goes off-shore. Capture value in US firms? Because off-shore more likely to be less scrupulous than unregulated US firms? Other? Explain.

(4) Treasury implies that a plausible legal argument could be made that "swaps" are covered by the CEA. But they go on to say that Treasury concludes that "swaps are not futures" and that "congress did not intend that swaps, or those who arrange wap transactions, should be subject to regulation under the CEA." Is it necessary to have the "swaps are not futures" language. CFTC did not include "swaps are futures" in the concept release (although they did say it previously). Isn't it sufficient to say "congress did not intend ...."

(5) Treasury makes only the most cursory nod at the concerns in the OTC derivatives markets. Even Greenspan noted recently that these transactions have never been tested in a down market. And Rubin has stated his concerns about the complexity of the deals leaving even sophisticated investors befuddled. God forbid a major pension plan looses its shirt in OTC derivatives while we are performing this study and workers are at risk of loosing retirement benefits. Wouldn't we be better off if we had at least acknowledged the concerns now. A few additional sentences from previous greenspan and rubin statements should suffice.

(6) Page 4, 4th paragraph -- Testimony says release raises concern even for those that are clearly within CFTC's exemptive authority because they've raised the spector of possible regulation. By this argument, we could never discuss possible regulation of any market because it might chill the market in anticipation of what the regulator "might" do. Also, I thought Treasury hasn't prejudged the issues, but this presumes that no regulation is appropriate.

Message Sent To:

Ingrid M. Schroeder/OMB/EOP
Derek A. Chapin/OMB/EOP
Theodore Wartell/OMB/EOP
Alan B. Rhinesmith/OMB/EOP
Edward A. Brigham/OMB/EOP
Jeremy B. Rudd/CEA/EOP
Michael Deich/OMB/EOP

Withdrawal/Redaction Sheet
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Doug Elmendorf to Gary Gensler and Roger Anderson re: Long-Term Capital (1 page)	09/25/1998	P5

COLLECTION:

Clinton Presidential Records
Council of Economic Advisers
Jason Seligman
OA/Box Number: 23925

FOLDER TITLE:

Working Group on Financial Markets (July 1997 - November 1998) [Binder] [3]

2010-0673-F
pr7

RESTRICTION CODES

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EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

SENIOR ECONOMIST

September 25, 1998

TO: Gary Gensler
Roger Anderson

FROM: Doug Elmendorf D.E.

SUBJECT: Long-Term Capital

I'm concerned that this statement sounds like it had never occurred to us that hedge funds could raise policy questions until this week. Is there some way to convey the sense that we've always been thinking about these issues, but this seems like an appropriate moment to raise their visibility? I'm sorry I don't have specific wording suggestions.

Within the context of what you've written, I have three small suggestions:

1. I'd drop the term "broader" in the second sentence.
2. I'd replace "the recent events surrounding LTC" with "these developments."
3. I'd mention "financial institutions" rather than just talking about "market participants."

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Withdrawal/Redaction Sheet
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. report	RE: Commission Hedge Fund Briefing [CEA (Commodity Exchange Act)] (7 pages)	n.d.	P3/b(3)
002. paper	[re: Systemic Risk...] [incomplete copy] (2 pages)	n.d.	P5
003. handwritten notes	re: WGFM (9 pages)	12/07/1998	P5

COLLECTION:

Clinton Presidential Records
Council of Economic Advisers
Jason Seligman
OA/Box Number: 23925

FOLDER TITLE:

Working Group on Financial Markets (December 1998 - August 1999) [Binder] [1]

Debbie Bush
2010-0673-F
db2069

RESTRICTION CODES

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failure exists.

Systemic risk arises from the failure of financial institutions because financial markets are characterized by contagion. Systemic risk occurs first and foremost through the network of interlocking claims and liabilities through interbank, over the counter derivatives and payments and settlements systems. Second, information asymmetries make can create contagion. Given the difficulty for creditors in judging the strength of a financial institution on the basis of publicly available information, creditors can take difficulties at one institution as indicative of potential vulnerability at other institutions with a superficially similar business structure. This arguably occurred in the Asian crisis. When contagion impacts banks the damage can be particularly large since banks are arguably special because of their central role in the payments mechanism and because of their role in creating credit.

I believe that a case could be made for regulation, in principle, even if financial markets were perfectly efficient; but there is clear evidence that they are not--that there are swings associated with irrational exuberance and depression. Individuals may suffer from disaster myopia, so that their subjective probabilities differ from objective reality. We see evidence of herd behavior. Regulation could potentially limit the negative consequences of these mood swings.

Asset price volatility can also be a cause for concern.

Although there is a strong theoretical case for regulation, it is perfectly possible that regulation could create more problems than it solves. So the answer as to whether the framework should be altered is yes, if it can be improved. I think the answer is yes. I also believe though that market discipline must be preserved.

What should we do?

There is a case for a lender of last resort in catastrophic cases (Greenspan.)
Deposit insurance is a guarantee against runs and a recognition of the vulnerability of banks to them, although they exacerbate the problem of moral hazard.
We should not try to avoid any financial institution failures.

Revise Basle Capital Standards
Improved capital standards--Capital standards are seriously broken. We need to improve measurement of risk and capital so that banks have adequate capital against the risks they run.

May also want to restrict activities of some financial intermediaries--part

2. If yes, should we address leverage in the system?

We should not address leverage per se, because it is too difficult to define given derivatives and is not the proper measure of the problem. We should control excessive exposure to risk. We should require that banks and possibly other financial intermediaries hold a certain minimum level of capital in relation to the risks in their portfolios. Risks need to be properly identified. At the moment that level of capital is also arbitrary. At present, capital requirements do not adequately reflect the relative riskiness ofa ssets in the portfolio, giving rise to regulatory arbitrage and possibly increased risktaking. We should also increase the supervision of risk management.

There is an argument to extend supervision to nonbank financial institutions and to try to overcome regulatory compartmentalization. We need to avoid a migration of business to market segments that are less strictly regulated.

Disclosure--clearly a case for improved disclosure, particularly for large institutions with market impact assuming large positions.

We should not make the best the enemy of the good.

WGFM

12/7/98

hearing on 16th
panel 1: CFTC Commissioners
2: Rich, Pat, Roger, Dan (CFTC)
3: Wendy Gramm, Susan Phillips

Rubin:

most current regulation focuses on safety and soundness of lending institutions — but maybe we should focus on effects on borrowers (Larry S.)

Greenspan:

reason for finan regulation is over-spill, which creates systemic risk

Rubin:

he's worried about flows to non-regulated borrowers (hedge funds, brokerages, other countries)

Greenspan:

obverse of reg. is leverage
risk of assets is key
this is a bigger problem now than 30 yrs ago, when assets & liabilities were plain vanilla
"system will not self equilibrate in long run from here"

Summers:

in crises, all correlations go to 1, so you can assume that and then have low capital ratios – or, use diversification in calculating risk and then have high capital ratios

AG: ① supports risk based capital (taking account of both assets and liabilities)

② "we have 3 yrs" before risk-taking builds up again

③ regulation cannot eliminate systemic risk

Rubin:

why should ~~Salomon~~ Salomon have capital standards but hedge funds do not?

(S. is largely a trading entity)

Greenspan:

do not regulate institutions if their failure only wipes out the positions of ~~the~~ creditors and equity holders
how does this relate to LTCM?
it's the only institution that got money w/o revealing its balance sheet –
a human failure

Levitt:

address disclosure right away
consolidated oversight may make sense

AG:

SEC has made a lot of progress voluntarily – which offers more flexibility as institutions evolve

Levitt

opposes legislative solutions
- no time
- don't know what we'll end up with

Seidman

can we increase information?
it's not all on the balance sheet any more

Summers

they weren't really surprised by leverage, perhaps, but by market movements

"portfolio insurance" failure was 90% analysis and 10% information

Born

We need prudential regulation + disclosure

same things as I banks and brokers

Summers:

maybe we learned that tails are fatter than we previously believed

Rubin:

at Goldman Sachs, they didn't maximize expected return because they didn't want to go bankrupt
we should have some sort of leverage rqmts, even though they won't be perfect

Yellen:

even if all knowledge were available, people will take excessive risk
- "too big to fail"
  - explicit safety net
  - limited liability of bankruptcy
  - spillovers we've discussed ~~that~~

⇒ systemic risk

a general argument for regulating risk

A.6.:

what do you do?
require general partnerships (like G-Sachs)
information is so complicated now

limit lending to them

Levitt:

what can we do in next 6-9 months?
disclosure not mutually exclusive to other things

Rubin:

"collective systemic risk" - if all funds do the same thing, they could all go together - bad, even if none is alone that large
need enough capital to avoid forced liquidation

A6:

should include stock mkt in discussion

Summers:

we've learned in last 6 mos. that you could have systemic risk without a stock mkt correction (contra 1929 and 1987)

A.G.:

"scariest moment in 50 years"
20% mkt. decline was having a big impact on institutions

Born:

importance of intl. coordination

Summers:

there are other contexts in which the govt. has less technical expertise than the people we're regulating – but we regulate for safety anyway

ex.: nuclear power plants, jet aircraft
airlines – we don't actually check the planes; we check the plane inspections of airlines

Levitt:

don't let possible grand restructuring blind us to short-term consciousness-raising cum ~~regula~~ supervisory changes

A.G.:

maybe we should do nothing
recent events have been the best regulatory ~~ev~~ change in years

Yellen:

create penalty structure to make managers give more weight to bad states of the world — then we don't have to micro-manage

Summers:

we need to capture everybody who is doing the same sorts of things (unregistered b-d affiliates, ~~s~~hedge funds)

this is the problem with ~~non-regul~~ non-legislative approaches

Born:

can you reach institutions because they seek U.S. investors?

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. draft	Robert Rubin and Gene Sperling to President Clinton (3 pages)	ca. 02/1999	P5
002. memo	Robert Rubin and Lawrence Summers to President Clinton (4 pages)	04/12/1999	P5
003. memo	Doug Elmendorf to Gary Gensler re: Draft Recommendations for Hedge Fund Report (3 pages)	03/31/1999	P5
004. memo	Doug Elmendorf to Gary Gensler re: Revised Recommendations for Hedge Fund Report (3 pages)	04/09/1999	P5

COLLECTION:

Clinton Presidential Records
Council of Economic Advisers
Jason Seligman
OA/Box Number: 23925

FOLDER TITLE:

Working Group on Financial Markets (December 1998 - August 1999) [Binder] [2]

Dana Simmons
2010-0673-F
ds371

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
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Freedom of Information Act - [5 U.S.C. 552(b)]

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EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

SENIOR ECONOMIST

MEMORANDUM FOR GARY GENSLER, Assistant Secretary of the Treasury (Financial Markets)

FROM: Doug Elmendorf DE

DATE: March 31, 1999

SUBJECT: Draft Recommendations for Hedge Fund Report

I think the draft recommendations are excellent. Janet Yellen is away this week, so she has not read the draft. Nevertheless, she believes that systemic risk is a serious problem to which unfettered private markets would give insufficient weight, and that there is little reason in principle to limit the regulation of risk-taking to depository institutions. So I think she will be very pleased to support the practical steps outlined in this draft to restrain excessive risk-taking. In addition, I think she will strongly favor the presentation of "additional potential steps" for the Working Group and others to consider.

Here are some specific comments on the first several pages of the recommendations. The only theme of these suggestions is to strengthen the basic economic rationale for the policies being proposed. I hope this is helpful.

Para 1

* I'm concerned that people will read the word "leverage" to mean "traditional measures of leverage," when what we really mean is "risk-taking," as reflected in traditional balance-sheet measures, off-balance sheet exposures, value-at-risk, etc. Can we say "excessive leverage and risk-taking" in the first sentence?
* "in the summer and fall of 1998"
* This doesn't define systemic risk or give any sense of how it could be affected by leverage. I'd replace the third and fourth sentences with: "By increasing the chance that problems at one financial institution could spread [or "be transmitted"] to other institutions, leverage can increase the likelihood of a general breakdown in the functioning of financial markets. Reducing such systemic risk is not a direct goal of most current financial regulation, although the regulation does cover most large concentrations of financial risk."

Para 2

* "larger and more highly leveraged than many hedge funds."
* To facilitate comparison of hedge funds and banks, be consistent in presenting numbers -- give the amount of capital or the amount of assets in all cases. (Part of the danger posed

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by LTCM arose from its gross positions, not just net positions, because the contracts would have been unraveled separately in the event of bankruptcy. So I'm not sure that the amount of capital is a sufficient statistic here.)

* Won't this scare people unduly about commercial banks? I think C-banks and I-banks are worth distinguishing for at least two reasons: 1) the former are regulated for safety and soundness, and the latter are largely not -- so the systemic risks they now pose are presumably quite different (if not, that's a pretty strong argument against bothering to extend the regulatory net); and 2) the former have deposit insurance and the latter do not -- so the government-budget risks they pose are quite different.
* The last sentence seems too mild after the preceding buildup. I'd say "... would generally be more able to ride out ..." -- after all, they did ride out the chaos of last year.

Para 3

* Again, I'd replace "leverage" with "risk" in the first sentence.
* The bullets confuse me. First, the previous paragraph suggests that the biggest institutions are an issue too, but then the bullets focus on the little guys (bullet 1) and on hedge funds (bullet 3). Also, the last bullet is really about the government, not about the market. Finally, I don't think that either the private or government restraints are as well developed as necessary. I suggest restructuring to include the following ideas. On the private side: 1) every firm has an incentive to restrain its risk taking to protect its own capital, and firm managers have an incentive to protect their own investments in the firm; 2) stockholders have incentives (and not just for hedge funds) and publicly available information; 3) creditors and counterparties have incentives and private information (including that which arises from clearing arrangements). Then I'd have a paragraph about the current government role: 1) "history tells us" that errors are a recurring phenomenon; 2) the government generally ensures fair markets, honest dealings, availability of correct information; 3) the government regulates for safety and soundness in limited cases, including when deposit insurance funds are at risk or when institutions are at the center of the payments system.
* How do custody services restrain leverage? (I'd have guessed that the custodian function involves no risk, in contrast to the credit and clearing functions.)
* "implement effective risk management ... discipline effective." (We're talking about levels, not changes, here.)

Para 4

* "In the case of LTCM, market discipline encouraged by government regulation was not effective in preventing trouble."
* The draft uses "investment banks," "broker-dealers" and "securities firms" somewhat interchangeably. I suppose that some variety in expression is good, but will people think the draft means different things when it switches to a different word?

Para 5

* How did these weaknesses become evident? Is it the result of the tumultuous markets last

year, or that the LTCM episode motivated regulators to poke around more, or the combination?

Para 6

* Is there evidence on recent changes in credit risk management for institutions besides hedge funds?

Para 7-8

* I think the "need for the following measures" should be motivated more clearly with a stronger chain of reasoning. At this point the arguments are: 1) mistakes will be made; and 2) systemic risk exists. But the first argument is not very strong by itself, because mistakes are made all the time in free markets and do not necessarily justify government action. And the second argument is not developed here at all. To strengthen the systemic risk argument, I suggest adding a few sentences about a systematic bias toward too much risk-taking in free markets (for example, page 66 of the Economic Report of the President has some language on this point, written by me with help from Roger Anderson and Pat Parkinson). To strengthen the "mistakes" argument, I suggest arguing that financial innovation has made the government's existing disclosure rules and regulatory approaches inadequate. This has two advantages: a) it helps to explain why we didn't have (or need) this policy in the past; and b) it helps to justify the range of actions we're proposing (we're not doing less, because that wouldn't update everything that needs updating, and we're not doing more, because we've already got the right concept about appropriate government involvement and all we need to do is update it).
* It would be useful if there were one bullet per bold numbered heading. (Currently there are two bullets on disclosure and one bullet for each other area.)
* The last bullet is less self explanatory than the others. Moreover, I think the last bold heading (which describes that bullet) is less clear than the others. "Expanding risk assessment" seems to mean collecting more information from broker-dealers but not being able to tell them what to do -- but this description is not completely obvious from the term itself, nor is it stated clearly. A quick reader might wonder how this differs from the first "additional potential step."

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

SENIOR ECONOMIST

MEMORANDUM FOR GARY GENSLER, Assistant Secretary of the Treasury (Financial Markets)

FROM: Doug Elmendorf D.E.

DATE: April 9, 1999

SUBJECT: Revised Recommendations for Hedge Fund Report

Thanks for your responsiveness to my previous suggestions. If you're still taking comments, here are a few suggestions on the revised draft.

Para 1

* The last clause sounds like a tautology: "... **regulation** does cover most large concentrations of financial risk at **regulated** financial firms." How about "regulation does cover **many** large concentrations of financial risk"?

Para 2

* Is the term "replacement value" of derivatives widely used?

Para 4

* I think the distinction between revenue sources and funding sources will be lost on some people. How about something a little more mechanical: "C and I banks can earn money in more diverse ways and can borrow money through more channels, than hedge funds ..."
* Higher operating expenses should be offset by higher revenue on average, since entry and exit into these businesses will tend to equilibrate risk-adjusted profit rates. So I don't think we want to suggest that these institutions can cope less well because they're less well off. Is the point that these expenses cannot be adjusted during bad times, so the stability of revenue just offsets the stability of costs? An easy nod in this direction would be to say "**fixed** operating expenses."

Para 5

* Drop "To further constrain financial institutions' leverage and" because you haven't yet discussed anything that this could be "further" than.
* I'd re-order the first three bullets. Put the second bullet first, because it's about what firms do to protect themselves (and could reinforce this point by adding at the end "to protect the capital and profitability of the firms"). Then the third bullet, which is about the basic watchdog of firms, their investors. Then the first bullet, which is a more specific point about how the little folks are policed by the big folks.

* I still think that the fourth bullet about government regulation is a funny "reason for believing in market discipline." More important, I think that readers need a clearer understanding of our current regulatory framework to appreciate the regulatory choices that we face going forward. I suggest a brief paragraph saying that the government now reinforces private market discipline in two general ways: one is ensuring well-functioning markets by preventing fraud, requiring that certain types of information be provided, etc.; the other is preventing excess risk-taking directly by regulating for safety and soundness. The former function applies to all financial-market institutions in some way; the latter is focused on institutions with insured deposits or that are central to the payments system.
* The acronym "SRO" should be explained or written out.

Para 7

* I'd put "complexity" first in your list, as that seems likely to have been the biggest problem.
* LTCM argues that developments around the world were more highly correlated last year than one would have predicted from historical data, because more institutions are now trading in the same markets and losses in one region led to "pulling back" in all regions. I can't really believe that they were surprised to find other institutions doing what they were doing. Still, the argument suggests that one failing of risk-management practices was not understanding that the activities of financial firms can change the underlying market processes. I also recall discussion at the last Working Group meeting about whether all correlations "go to 1" in crises. Maybe your list should say "... complexity, volume, leverage, and interrelationship of transactions ..."
* As I suggested before, I think it's useful to emphasize the idea that financial-market innovation has made the existing disclosure rules and regulatory approaches inadequate. I'm not sure how much of the story this really is, but it's a convenient argument because it absolves us of regulating badly in the past and neatly justifies the range of actions we're now proposing.

Para 8

* The sentence "Additionally, ... meaningful limits to exposures" seems funny here; isn't the preceding paragraph all about why they didn't establish meaningful limits? Why not move the "meaningful limits" idea up two paragraphs into the "very generous credit terms" sentence, and then move the "complacency" sentence into the preceding paragraph?

Page 4

* You do not summarize the new legislation that will be required to implement the proposed measures, although there are specific mentions along the way. Maybe there are good reasons for not summarizing that separately, but it seems that a report to Congress might usefully conclude with a section on "what should Congress do."

Page 11

* The bullet on broker-dealers implies fairly strongly that consolidated supervision would be

a good thing. You discuss a "gap" in current practice and argue that the gap raises systemic risk; also, in contrast to the other bullets, you don't mention any implementation problems or disadvantages of such regulation. I don't object to this spin, because I am also more inclined toward consolidated supervision than the other steps on this page. But some readers may ask why, in light of this paragraph, the Working Group shied away from this step, and the less regulation-minded members of the working group may worry about that perception.

* Why are the last paragraphs in brackets? For what it's worth, they seem fine to me.

Withdrawal/Redaction Sheet
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. note	re: Comments on Draft Gensler Testimony (2 pages)	n.d.	P5
002. email	Sarah Rosen Wartell to Carol R. Dennis et al. re: Treasury Testimony on CFTC (1 page)	05/17/1999	P5
003. email	Sarah Rosen to Richard L. Siewert et al. re: POTUS Statement (2 pages)	04/28/1999	P5

COLLECTION:

Clinton Presidential Records
Council of Economic Advisers
Jason Seligman
OA/Box Number: 23925

FOLDER TITLE:

Working Group on Financial Markets (December 1998 - August 1999) [Binder] [3]

2010-0673-F
pr8

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
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b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

Comments on Draft Gensler Testimony
Doug Elmendorf

Most of these comments are small points of clarification. Here they are in order:

Page 1:

Para 3 Define "Working Group" and "OTC." In a nod to Sarah Rosen's concern about the pessimism of "it would not be surprising not to agree," you could make it "it is unclear whether we will agree,"

Para 4 Describe "notional value" in a phrase. Add "and households" to the end of the paragraph: it's true a little bit directly (some farms are still family farms) and true a lot indirectly; anyway, it makes us sound less like cheerleaders for businesses.

Para 5 Is this paragraph an overview of the next several? Then paragraph 6 should lead off with a "First,". Also, I don't think you need both "can help" and "potentially".

Para 7 This won't mean anything to most folks. How about: "... derivatives markets help participants in other financial markets determine consistent prices for the assets they are trading. This helps ..."

Page 2:

Para 3-6 This structure confuses me. Isn't there one issue here: risk management (of which I assume leverage is a component)? I'd have one paragraph about that problem and one about considering whether the government should get involved.

Title The following section is not about the CFTC per se, but about "Current Derivatives Regulation and Useful Changes" more generally. Indeed, you say nothing whatever about *which* regulatory agency should have responsibility here. I'd change the name of the section and also admit explicitly somewhere that you're not going to talk about choice of regulator at this point.

Page 3:

Para 5 Shouldn't you clarify (as you do in other places) that it is *Treasury's* view that the Treasury Amendment should be amended? (If at first your amendment doesn't work, try, try again.)

Para 6 Where does the phrase "bucket shop" come from?

Page 4:

COPY

Para 2 Doesn't the "blurring" in the last sentence really involve the difference between "OTC" and "organized exchanges" rather than the difference between "swaps" and "futures"?

Para 3 A more permanent clarification is "likely" to be necessary? This seems pretty weak tea considering the umbrage about the Concept Release.

Para 4 Deja vu. This language looks vaguely familiar at this point.

Sarah Rosen Wartell
05/17/99 01:51:09 PM

Record Type: Record

To: Carol R. Dennis/OMB/EOP, Richard E. Green/OMB/EOP

cc: See the distribution list at the bottom of this message

Subject: Treasury Testimony on CFTC

I am not going to object to clearance of the testimony as is. However, I share with Treasury my thoughts on a few issues for their consideration:

(1) What purpose is served by saying "it would not be surprising if we are unable ot reach agreement on some of these issues." It can only poison the quality of the dialog in remaining efforts to try to reach consensus. You mention the same thing at the end of the testimony but there it seems less inflamatory. At minimum, no need for both.

(2) Page 4, first line -- "swaps are not futures under the CEA." In many places, we say "the President's WG is looking at the issue...." but here you choose to preempt the outcome of the study. Given views you stated in the context of the standstill this won't surprise anyone, I guess.

(3) In the third full paragraph on page 4 you make some of the same points that you make at the top of the page on the second point. Can this be reorganized to not be redundant???

Message Copied To:

gary.gensler @ do.treas.gov
Douglas W. Elmendorf/CEA/EOP
Derek A. Chapin/OMB/EOP
Edward A. Brigham/OMB/EOP
Alan B. Rhinesmith/OMB/EOP
Theodore Wartell/OMB/EOP
Michael Deich/OMB/EOP

Sarah Rosen
04/28/99 10:27:07 AM

Record Type: Record

To: Richard L. Siewert/WHO/EOP, Melissa G. Green/OPD/EOP, Douglas W. Elmendorf/CEA/EOP

cc: gary.gensler @ do.treas.gov, robert.boorstin @ do.treas.gov
Subject: POTUS STATEMENT

Treasury has proposed the following. I think it is hard for someone not familiar with the topic to know what it means and how it relates to average americas. I propose some edits below. I will be out most of the day, so Jake please coordinate with Treasury on final language. Doug -- You are close to this, welcome your thoughts. Thanks.

Treasury Language:

As part of my Administration's ongoing efforts to increase opportunities and reduce risks in the global economy, we have focused on ways to strengthen the world's financial system in order to increase growth and raise living standards. Today, I welcome the release of the President's Working Group on Financial markets' report that focuses on a key aspect of that challenge: excessive leverage.

Taken together, the report's recommendations are an important first step in our efforts to promote more secure financial markets for all investors. By increasing the amount of information made available to the public and by improving risk management on the part of financial institutions, we can help reduce the potential risks associated with excessive leverage, as demonstrated by the near-collapse of Long-Term Capital Management.

I want to commend the working group for this thoughtful report. I look forward to working with Congress on these important issues.

First Cut Revision:

A strong and stable world financial system is important to America's continuing prosperity. My Administration has worked to increase opportunities and reduce risks for investors in the global economy, because secure financial markets are necessary if we hope to continue economic growth and rising living standards for all Americans.

[NEED DESCRIPTION OF WHAT EXCESSIVE LEVERAGE IS -- FEEL FREE TO MODIFY: When financial institutions extend excessive credit to major investors, the negative effects of any investment gone bad are magnified and the risk that problems at one financial institution can be transmitted to others is increased. The near-collapse of Long-Term Capital Management last ___ demonstrated these risks. Such excessive leverage can increase the likelihood of a general breakdown in the functioning of world financial markets.]

I welcome today the release of a report from the President's Working Group on Financial Markets -- which includes all the U.S. government's financial regulators and policy makers -- that focuses on problems raised by excessive leverage. The report recommends that we increase the amount of information made available to the public about the ____ of ____ and that we improve risk management on the part of financial institutions. Implementing these recommendations will be an important step in our efforts to promote more secure financial markets for all investors.

I want to comment the Working group for this thoughtful report and especially the Working Group's Chairman, Secretary Rubin, for his continued leadership in this area. I look forward to working with Congress on these important issues.

Withdrawal/Redaction Sheet
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	William F. Wiggins to Alan B. Rhinesmith et al at 13:47:39.00. Subject: CFTC Treasury Amendment Briefing (2 pages)	01/31/1997	P5
002a. email	Martha Solt to Norman Carlton et al at 09:18:46.00. Subject: Revised List of Steering Committee Attendees [partial] (1 page)	03/23/1998	P6/b(6)
002b. list	List of Steering Committee Attendees [partial] (4 pages)	03/23/1998	P6/b(6)
003. email	Theodore Wartell to Sarah Rosen at 18:34:49.00. Subject: OTC Derivatives Oversight Controversy (3 pages)	06/02/1998	P5
004. email	Sarah Rosen to Melissa Green et al at 19:25:50.00. Subject: Weekly (1 page)	08/27/1998	P5
005. email	Sarah Rosen to Brian A. Barreto at 22:22:00.00. Subject: 7:45am Memo (2 pages)	10/15/1998	P5
006a. email	Kitty Chaney to Warren Gorlick et al at 11:57:02.00. Subject: Steering Committee Phone Directory [partial] (1 page)	11/20/1998	P6/b(6)
006b. list	Steering Committee Phone Directory [partial] (3 pages)	11/20/1998	P6/b(6)

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[01/31/1997 - 12/04/1998]

Jamie Metrailer
2010-0673-F
jm166

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RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: William F. Wiggins (CN=William F. Wiggins/OU=OMB/O=EOP [OMB])

CREATION DATE/TIME:31-JAN-1997 13:47:39.00

SUBJECT: CFTC Treasury Amendment briefing

TO: Alan B. Rhinesmith (CN=Alan B. Rhinesmith/OU=OMB/O=EOP @ EOP [OMB])
READ:UNKNOWN

TO: Edward A. Brigham (CN=Edward A. Brigham/OU=OMB/O=EOP @ EOP [OMB])
READ:UNKNOWN

TO: Michael Deich (CN=Michael Deich/OU=OMB/O=EOP @ EOP [OMB])
READ:UNKNOWN

CC: Peter O. Davis (CN=Peter O. Davis/OU=OMB/O=EOP @ EOP [OMB])
READ:UNKNOWN

CC: Daniel M. Tangherlini (CN=Daniel M. Tangherlini/OU=OMB/O=EOP @ EOP [OMB])
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CC: James J. Jukes (CN=James J. Jukes/OU=OMB/O=EOP @ EOP [OMB])
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CC: Patricia E. Romani (CN=Patricia E. Romani/OU=OMB/O=EOP @ EOP [OMB])
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CC: Ingrid M. Schroeder (CN=Ingrid M. Schroeder/OU=OMB/O=EOP @ EOP [OMB])
READ:UNKNOWN

CC: Ellen S. Seidman (CN=Ellen S. Seidman/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TEXT:
Yesterday, Ingrid Schroeder and I attended a briefing that I requested with CFTC staff (Exec. Dir. Don Tendick and others) to discuss the "Treasury Amendment" and the agency's disagreement in this area with the Department of Treasury. The following summarizes the policy issues and concerns in developing an Administration position on amending this provision.

Summary
The "Treasury Amendment" of the Commodity Exchange Act (CEA) of 1974 preempts CFTC regulation of "transactions in foreign currency, security warrants, and other financial instruments." It originally was inserted into the CEA at the behest of the Dept. of Treasury, which was concerned that allowing CFTC to regulate these transactions would unnecessarily duplicate the oversight provided by bank regulators and the SEC. Since its enactment, however, the Treasury Amendment has been the subject of substantial debate and controversy.

Issue
Last year, Sen. Lugar and Sen. Leahy asked CFTC and Treasury to develop a solution to the regulatory uncertainty caused by the Treasury Amendment and to report back by the end of the calendar year. The agencies were unable to resolve their differences in time. As a result, CFTC -- which has statutory legislative bypass and does not have to comply with OMB's clearance process -- sent its reply to the Hill. Treasury now wishes to

respond to the issues raised in CFTC's letter and has submitted a draft letter to OMB for immediate clearance. (According to the CFTC, the agencies are still trying to work together.) However, it now appears that Congress will step in and impose its own solution if an agreement cannot be reached between Treasury and CFTC.

The disagreement between CFTC and Treasury stems from the original drafting of the Treasury Amendment, recent court actions (including the Dunn case currently in front of the Supreme Court), and several major marketplace and financial instrument innovations. The agencies agree that: 1) the institutional over-the-counter foreign exchange and interbank markets provide substantial benefits to the public and global economy and that their current level of efficiency should be maintained; and 2) futures and options should be treated the same under the law. However, they generally disagree on: 1) how to police fraud and price manipulation in these markets; 2) how non-bank entities involved in these markets should be regulated; and 3) which agency should have oversight of the entities that sell these instruments to the public.

Recommendation
With the agencies struggling to reach agreement, and time running out before Congress acts, I recommend the Administration make an effort to reach consensus. In particular, I agree with CFTC's recommendation that either the President's Working Group on Financial Markets convene on fairly short notice or OMB and NEC push the two agencies to work out their differences. How do you think we should proceed in bringing the agencies together. Ellen Seidman is already aware of the issues involved.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Theodore Wartell (CN=Theodore Wartell/OU=OMB/O=EOP [OMB])

CREATION DATE/TIME: 2-JUN-1998 18:34:49.00

SUBJECT: OTC Derivatives Oversight Controversy

TO: Sarah Rosen (CN=Sarah Rosen/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TEXT:
---------------------- Forwarded by Theodore Wartell/OMB/EOP on 06/02/98 05:21 PM ---------------------------

Derek A. Chapin
06/02/98 05:48:43 PM
Record Type: Record

To: Michael Deich/OMB/EOP
cc: See the distribution list at the bottom of this message
Subject:OTC Derivatives Oversight Controversy

This memo provides background and analysis concerning the recent proposals from the SEC and CFTC concerning oversight and regulation of the OTC derivatives, or "swaps", market. Treasury, the FED, and the SEC all object to the CFTC's concept release, and have drafted legislation that would prohibit the CFTC from any rulemaking until after FY 2000, while the President's Working Group on Financial Markets studies the issue. The proposed legislation is currently circulating as an LRM (IMS339) with a comment deadline of Noon Wednesday, June 3. Treasury Secretary Rubin has talked with Gene Sperling concerning the legislative proposal.

FIB recommends the following:

1. The legislative proposal as currently drafted only exempts the CFTC from promulgating rules regarding regulation of OTC derivatives. The SEC should also be exempted from rulemaking to ensure a level playing field while the issue is studied.

2. In addition to their frequent infighting, the members of the President's Working Group have usually excluded OMB and the CEA from discussion and review of these issues. OMB and CEA should be involved in the review of the study and any resulting legislative proposals.

What are swaps?

Swaps contracts are used by institutional investors to hedge risks stemming from, for example, currency and interest rate fluctuations. Unlike the regulated, standardized futures contracts traded on exchange floors (Chicago Board of Trade, Chicago Mercantile Exchange, etc), swaps are customized contracts traded directly between institutions. Since the contracts are traded off-exchange, traders are not required to register with the CFTC or to meet any capital requirements. The swaps market has an estimated notional value of $30 million -- and growing exponentially -- and a trading volume some nine times exchange volume.

What have the SEC and CFTC proposed?

Since trading activity in the OTC market is dominated by sophisticated institutional investors, in 1993 the CFTC exempted swaps and hybrid instruments (products that combine characteristics of futures with securities or bank deposits) from being regulated as futures. The market has evolved considerably in the ensuing five years, however, prompting both the SEC and CFTC to propose regulatory initiatives.

1. SEC proposal. Called "Broker/Dealer Lite", the SEC proposal would allow OTC dealers to combine their equity derivatives business and other derivatives activity in a single unit (many equities trades occur on overseas markets to avoid capital and margin rules). This subsidiary unit would shoulder a lighter regulatory burden than a full-fledged securities broker-dealer in terms of margin, capital records, and bookkeeping. Currently the SEC's oversight covers only equity derivatives, a scant 1.4 percent of the market. Combining theses operations, however, would effectively give SEC purview over instruments outside its jurisdiction.

2. CFTC proposal. CFTC's concept release makes no recommendations, and clearly states that all current exemptions and interpretations remain in effect. Rather, the release lists numerous questions about the market, along with possible changes to CFTC rules. The key questions are:

Given that some swap agreements have become highly standardized, should they no longer be exempt from regulation?
Should the rules regarding eligibility for trading swaps be modified?
Should swap clearing facilities be permitted?
Would registration requirements for dealers or intermediaries be useful?
Are capital requirements necessary?
Are sales practice requirements needed?
Should swaps participants be subject to reporting requirements?

Within hours of the CFTC's release, Rubin, Greenspan, and Levitt issued a joint press statement, proclaiming their "grave concerns about this action and its possible consequences." Although the release makes no regulatory changes, CFTC's critics maintain that the agency has already decided its stance, and that the release is merely pro forma.

What are the contentious issues?

1. SEC / CFTC turf battle. For five years, all parties agreed that the swaps market would be exempt from regulation. Once the CFTC received wind of the SEC's "Broker/Dealer Lite" plan, they responded within weeks with their concept release. Although the CFTC exempted swaps from regulation, they are unwilling to cede jurisdiction over any instruments resembling futures to the SEC. The CFTC views the SEC's proposal as encroachment, while the many forces arrayed against the CFTC (Treasury, FED, SEC, and most of the futures industry) regard the CFTC's concept release at best a mere exercise in turf protection and at worst a destructive exercise in regulatory over-reaching.

2. Legal uncertainty. The CFTC's opponents contend that the agency, by raising the issue of whether swaps are futures, creates legal uncertainty. Dealers fear that a party on the losing end of a trade may refuse to pay by contending that the transaction was actually an illegal off-exchange futures contract. All fear that such uncertainty would drive

more swaps business overseas.

3. OTC markets working fine now. Due to the sophistication of the players, swaps dealers contend that increased regulation is unnecessary and will only result in more business migrating overseas. However, the markets are drawing some business from the exchanges, and there is a public-policy interest in having futures markets with sufficient business to ensure liquidity (argument for light regulation by CFTC).

4. Regulatory expertise. While the SEC has experience regulating broker-dealers, they don't have expertise in futures markets. The CFTC has the expertise, but the firms it regulates generally don't trade swaps.

5. SEC / CFTC merger. As financial markets continue to evolve, it will become increasingly difficult to draw clear jurisdictional lines, as the Treasury/Fed/SEC are asking of Congress. Since the CFTC is a rather weak agency with many opponents, and since this issue has furthered the perception that the CFTC is an out-of-control regulator, the calls from the Hill and the industry to merge the two agencies will likely increase.

Message Copied
To:
Theodore Wartell/OMB/EOP
Patricia E. Romani/OMB/EOP
Alan B. Rhinesmith/OMB/EOP
Edward A. Brigham/OMB/EOP
James J. Jukes/OMB/EOP
Ingrid M. Schroeder/OMB/EOP
Courtney B. Timberlake/OMB/EOP

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Sarah Rosen (CN=Sarah Rosen/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME:27-AUG-1998 19:25:50.00

SUBJECT: Weekly

TO: Melissa G. Green (CN=Melissa G. Green/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TO: Brian A. Barreto (CN=Brian A. Barreto/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TEXT:
Bankruptcy: Senator Lott said in August that the Senate would take up bankruptcy legislation late next week and vote soon after Labor Day. Republicans plan to offer a manager's amendment addressing one key aspect of the Administration's proposal, but not address all our concerns. They may accept modest Democratic amendments that incorporate a few other aspects of our plan. However, Democrats are expected to offer many other amendments (some of which we would not support). Moreover, Senator Kennedy has pledged to offer a minimum wage amendment. Campaign finance reform and the Patient's Bill of Rights could arise as well. It is unclear whether a cloture motion would succeed under those conditions, even though some Democrats would probably support the bankruptcy bill with a few additional changes. OLA, NEC and DoJ staff will meet with Senate Democratic staff on Monday to get a better sense of their strategy. Larry Stein and I have concluded that the best strategy for us, for now, is to lay low. We do not want to infuriate Democrats by negotiating with the Republicans and appearing to undercut their strategy. Moreover, we view the prospects of legislation to our liking emerging from conference to be very slim, even if an acceptable bill were obtained in the Senate.

Y2K Liability Reform: Just before the recess, Representatives Dreier and Eshoo introduced an alternative to our "good Samaritan" bill. While pleased that industry did not seek a bill that went beyond protection of information exchange to provide protection from liability for product failures, we concluded that the Dreier/Eshoo bill could hurt consumers and would indirectly affect underlying contract and liability claims that we had sought to leave untouched. Industry factions continue to debate amongst themselves, making prospects for passage of any bill increasingly slim. John Koskinen, with NEC, WH Counsel, OVP, and DoJ assistance, will be meeting with the Senate staff and industry representatives next week to try to hammer out an acceptably narrow bill that can be accomplished in the time remaining.

Stock Market: The Stock Market dropped over 350 points on Thursday (August 27) but, due to changes made by the exchanges last April at the urging of the Treasury, Federal Reserve, SEC, and CFTC, trading was not halted. As you will recall, circuit breakers were last triggered on October 27, 1997 when the Dow Jones Industrial Average (Dow) fell 350 points at 2:35 PM (halting trading for 30 minutes) and 550 points at 3:30 PM (halting trading for the rest of the day). Thereafter, the President's Working Group on Financial Markets argued that trigger levels should be increased. Markets should remain open as long as they are functioning efficiently. Circuit breakers were introduced after the October 1987 crash to halt trading during market declines of historic proportions and to substitute an orderly, pre-planned halt for the ad hoc trading halts that can occur during a dramatic and destabilizing decline. Increased system capacity and higher market levels meant that drops of 350 points could be handled efficiently under normal procedures. Under the new rules, trigger levels are established quarterly as a fraction (10%, 20%, and 30%) of the average Dow for the previous month. This quarter, it will take a 900 point drop in the Dow to halt trading for 1 hour.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Sarah Rosen (CN=Sarah Rosen/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME:15-OCT-1998 22:22:00.00

SUBJECT: Re: 7:45am memo

TO: Brian A. Barreto (CN=Brian A. Barreto/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TEXT:

Securities Litigation Reform: SEC is still working with members to correct and clarify record. Will not withdraw support but ask continued silence because possibility of veto makes folks more amenable to correcting record. SEC will draft a signing statement for our review.

Y2K Liability Reform Bill: Bill arrived at WH Thursday (10/8). Scheduling request submitted for signing ceremony to highlight bipartisan cooperation from Senate Judiciary Committee (Hatch, Thompson, Kyl, Leahy, Dodd) on important solution first proposed by POTUS.

Bankruptcy Reform: Reauthorization of Family Farm Chapter 12 : Nadler tried to get House to take up a 2 year extension of Chapter 12 on the suspension calendar on Thursday, but at the last minute the Republican leadership switched it with a 6 month extension. Durbin is trying to get a permanent extension attached to a bill from Rep. McCullom now on Senate floor. Not heard anything about Senators Feingold and Daschle's amendments to Family Farm Chapter.

Bankruptcy Reform: Financial Cross-Netting. Not heard anything about proposal from President's Working Group on Financial Markets. Expect that Grassley opposed.

Bankruptcy Reform: Authorization of temporary bankruptcy judgeships. Not heard anything else.

Bankruptcy Reform: Recording Industry Provision: Unions objected to inclusion in Omnibus of the provision that they had accepted in the context of the big bankruptcy bill. Dead.

Bankruptcy Reform: Spectrum Licenses. Senator Durbin and Rep. Nadler's staff called on Thursday upset to hear that FCC had gotten agreement from leadership to include a provision that would resolve pending bankrutpcy cases in which Block C bidders in bankruptcy attempt to hang on to licenses. Proposal has been in Admin budget 2 years in a row. DoJ and OMB strongly support. Administration had happily agreed to use (or suggested using) it as an offset. Worked on technical issues with Deich.

Vicarious Liability for Car Leasing Companies: Got calls on Thursday from attorneys for proponents of this provision from the product liability bill. They were disappointed to learn that we did not think that it was appropriate to legislate tort reform piecemeal in a budget bill. Bruce Lindsey sent message (thru his assistant) that he thought we should oppose inclusion of this provision, but not go to the mat to block.

Securities Litigation: SEC is still working with members to correct and clarify record. Will not withdraw support but ask continued silence because possibility of veto makes folks more amenable to correcting record. SEC will draft a signing statement for our review.

Class Actions: OMB has clear direction not to allow in Omnibus.

Y2K Liability Reform: Bill delivered to WH last Thursday (10/8). Awaiting decision re bill signing.

Amish Child Labor: Heard indications that the Omnibus may include a provision designed to block DoL enforcement of child labor laws against Amish saw mills. DoJ had constitutional concerns about earlier drafts. Unclear if a new draft will be offered that resolves those concerns. DoL is urging us to block it, but Tramontano and I agreed we should give it a shot, but not fight too hard.

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	Sarah Rosen to Jonathan Orszag et al at 19:53:29.00. Subject: Comments on Economic Report of the President (2 pages)	12/21/1998	P5
002. email	Cordelia W. Reimers to Sarah Rosen et al at 09:53:39.00. Subject: Comments on Economic Report of the President (2 pages)	12/22/1998	P5
003a. email	Martha Solt to Sarah Bryant et al at 08:35:56.00. Subject: Revised List of Attendess - Steering Committee for the President [partial] (1 page)	02/11/1999	P6/b(6)
003b. list	List of Attendess - Steering Committee for the President [partial] (2 pages)	02/11/1999	P6/b(6)

COLLECTION:

Clinton Presidential Records
Automated Records Management System [Email]
OPD ([Presidents Working Group on Financial Markets])
OA/Box Number: 250000

FOLDER TITLE:

[12/17/1998 - 05/06/1999]

Jamie Metrailer
2010-0673-F
jm167

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P5 Release would disclose confidential advice between the President and his advisors, or between such advisors [a)(5) of the PRA]
P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.
PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).
RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

b(1) National security classified information [(b)(1) of the FOIA]
b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
b(3) Release would violate a Federal statute [(b)(3) of the FOIA]
b(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Sarah Rosen (CN=Sarah Rosen/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME:21-DEC-1998 19:53:29.00

SUBJECT: Comments on Economic Report of the President

TO: Jonathan Orszag (CN=Jonathan Orszag/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

CC: Sally Katzen (CN=Sally Katzen/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

CC: Jeff B. Liebman (CN=Jeff B. Liebman/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

CC: Cordelia W. Reimers (CN=Cordelia W. Reimers/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

CC: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
I reviewed what I was sent -- chapters 2 and 4.

On Chapter 2:

Hedge Funds. I wanted to make sure that the Department of Treasury would have a chance to review the discussion of Hedge Funds and was assured that they would. In addition, I was concerned by the discussion on pages 32 - 34 about hedge fund regulation. The first page and half discusses possible reasons to regulate hedge funds. The next page or so discusses why caution is required before deciding that further government regulation is desireable. The section ends without any conclusion. Given that it ends with reasons why not to regulate, the impression left is that the report cautions against regulation. The President's Working Group on financial markets is considering, in response to a Congressional request, whether or not to recommend additional regulation and the Treasury Secretary is currently inclined to advance some greater regulatory role. Thus, so that the impression of a disagreement is not left, I think the text on page 33-34 needs to be reviewed and a neutral conclusion added, perhaps with a reference to the deliberations of the PWG. I have discussed this with Doug Elmendorf, author of this section, and he concurred.

Effects of Y2K: In general, this is a balanced discussion of the competing considerations in an analysis of whether there will be a significant economic impact from Y2K. At the end (p. 55), it says: "To summarize, even if disruptions turn out to be on the serious side, most likely they will show up primarily as inconveniences and losses in some individual sectors, and not in noticeable macroeconomic terms." However, I was concerned that the two paragraphs beginning with "Effects on the supply side --- ..." on page 53 through the middle of page 54 could be taken out of context. For example, the sentence on p.53 "There is no way to evaluate, for example, whether Y2K glitches in the financial sector will give enough substance to irrational end-of-millenium unease that the result will be self-confirming volatility in securities markets." Similarly, on page 54,: " There is no way of knowing the odds that the problem will lead to a recession in the year 2000."

COPY

I think each of these sentences needs to be rewritten to give more balance and suggest the more sanguine conclusion that the overall section has -- otherwise, they could be taken out of context to support end-of-millenium anxiety.

Chapter 4

Pension Issues

In general I think this is an excellent discussion of complex issues about which CEA is far more knowledgeable than I. I note that Jeff Liebman should review closelythe discussion on page 39-40 -- about the relative desireability of Defined benefit and defined contribution plans for women -- as I know he has views on the subject.

Finally, in two places in this chapter (pp 39 and 47), it references a to be added discussion about educational initiatives in the administration to promote retirement savings and education. I would like a chance to review these sections when written.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Cordelia W. Reimers (CN=Cordelia W. Reimers/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:22-DEC-1998 09:53:39.00

SUBJECT: Re: Comments on Economic Report of the President

TO: Sarah Rosen (CN=Sarah Rosen/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

CC: Robert F. Schoeni (CN=Robert F. Schoeni/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

CC: Jeff B. Liebman (CN=Jeff B. Liebman/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TEXT:
Thanks for your comments on Chapter 4, Sarah.
Bob: please note that Sarah wants to see the section on retirement savings and education to review as soon as it has been drafted.
Jeff: have you received a copy of Chapter 4 to review? We'd like to have your comments on the sections on pensions and SS.

Sarah Rosen
12/21/98 07:52:38 PM
Record Type: Record

To: Jonathan Orszag/OPD/EOP
cc: Douglas W. Elmendorf/CEA/EOP, Jeff B. Liebman/OPD/EOP, Cordelia W. Reimers/CEA/EOP, Sally Katzen/OPD/EOP
Subject:Comments on Economic Report of the President

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