TESTIMONY OF
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MANAGING DIRECTOR OF MORGAN STANLEY & CO. INCORPORATED
ON BEHALF OF THE
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON
REFORM OF THE OVER-THE-COUNTER DERIVATIVE MARKET:
LIMITING RISK AND ENSURING FAIRNESS

OCTOBER 7, 2009

Chairman Frank, Ranking Member Bachus, and members of the Committee:

My name is Jim Hill and I am a Managing Director of Morgan Stanley. I am appearing on behalf of the Securities Industry and Financial Markets Association ("SIFMA")[1] and its members. Thank you for your invitation to testify today.

The membership of SIFMA is diverse and includes financial firms of different sizes as well as firms that are active in different parts of the financial services business. Although my testimony today is being presented on behalf of firms that provide financial services, it also is focused on the interests and concerns of those firms' customers, the end users that benefit directly from the broad availability of

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, DC, and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

derivatives transactions to manage various risks that arise in connection with their day-to-day business and other activities.[2] SIFMA's members have built successful derivatives businesses by offering products that meet important needs of their customers, and it is in their interest to support legislative and regulatory measures that will improve the integrity and functioning of the derivatives products and markets. Such measures serve the interests of all participants, the dealers *and* their customers. At the same time, SIFMA's members are concerned about proposals that may unnecessarily limit the availability or usefulness of derivatives transactions, or impose significant new costs in connection with their use. We believe that a guiding principle for congressional action should be not to impose new regulations that will limit the availability or usefulness of derivatives or increase their cost unless there is a compelling reason to do so.

There is much in the Committee's Discussion Draft of the Over-the-Counter Derivatives Markets Act of 2009 (the "Act") that SIFMA and its members support and we believe it includes many significant improvements over the Administration's proposed legislation from last August. We appreciate the thoughtful consideration that you and your committee colleagues and staff have given to comments on the Administration's proposal that you have received from interested parties on all sides, including in particular those of end users.

[2] On October 2, 2009 the Coalition for Derivatives End Users circulated to Members of Congress a letter signed by 171 companies and business organizations from across the country noting the importance of OTC derivatives for risk management.

I would like to begin by expressing SIFMA's support for legislative proposals to ensure that systemically significant market participants are subject to comprehensive regulatory oversight. It was the lack of meaningful regulation of AIG's derivatives affiliate that allowed poor business practices to lead to a situation in which the federal government had to invest tens of billions of dollars in that enterprise in order to avert what could possibly have been a systemically significant business failure. The Act would address this regulatory shortcoming by creating a legislative and regulatory framework that ensures such a lapse should not occur again.

We also support measures that will improve regulatory transparency and thereby facilitate oversight of derivatives markets and the activities of individual market participants. The Act accomplishes this by requiring that swaps either be submitted to a derivatives clearing organization (the CFTC is authorized to determine which swaps are required to be cleared) or be reported to a swap repository or the CFTC. Similar requirements are imposed with respect to security-based swaps (with the SEC making the determination).

Centralized clearing of swaps has numerous benefits, and we support efforts to encourage more clearing. In fact, derivatives dealers have been actively working toward, and providing commitments to ensure, increased levels of clearing.[3] Over the course of the last few years, financial firms have collectively worked to increase standardization in the derivatives market, which – along with appropriate liquidity -- is one of the necessary predicates to effective clearing. Furthermore, last month 15 of the largest OTC derivatives dealers set specific goals for expanding central clearing of credit and interest rate derivatives in a letter to New York Federal Reserve Bank President William C. Dudley. These initial goals involve clearing a greater percentage of new trades and historical trades, and will be increased as clearing infrastructure expands and a greater range of products become suitable for clearing. These directives build upon earlier commitments to implement changes to risk management, enhance reporting of non-cleared trades, and improve governance – all tools that increase the transparency of the derivatives markets.

We believe that by combining complete regulatory transparency with meaningful, comprehensive oversight, the Act corrects the situation that allowed the AIG problem to develop. The Act, though, would do more than this and its provisions are both extensive and complex. SIFMA and its members have identified a number of concerns regarding the Act's effects on various aspects of the derivatives market and its consequences for dealers and, in particular, their customers.

[3] As of October 1, 2009, $ 3 trillion in U.S. CDS had been cleared and major dealers have committed to individually submitting 90% of new eligible trades in interest rate derivatives beginning December 2009 and 95% of new eligible trades in credit default swaps beginning October 2009.

Although the Act generally excludes corporate end users from provisions that would require exchange trading or clearing of swap transactions, they *would* be covered by other provisions. For example, the Act would authorize regulators to impose margin requirements on swaps in which one of the counterparties is an end user. It is difficult to understand why counterparty credit exposure created through a swap transaction should be required to be collateralized when lending arrangements between the parties can be made on an unsecured basis. The Act would direct regulators to allow parties to post non-cash collateral, but even that carries a cost, including reducing the end user's borrowing capacity and potentially causing an end user to violate negative pledge covenants. Another provision concerns dealer segregation of funds or other property posted as margin. We believe it is important for end users to have that option in connection with over-the-counter swaps, but both the decision to require margin and the details of how it is handled should be left to negotiation between the dealer and the end user in the ordinary course of their lending and risk management processes.

The Act is appropriately focused, in particular, on the activities of swap dealers and major swap participants. We believe, however, that the definition of "swap dealer" may be overly broad in that it could capture entities that would not traditionally be considered "dealers." While a fund that buys and sells significant levels of derivatives for investment purposes could fall within the definition of "major swap participant" (or "major security-based swap participant"), the determination of whether that fund was also a swap dealer should depend on whether the fund held itself out as willing to make two-way markets in swaps.

SIFMA members also are concerned about the business conduct rules in the Act that would require the disclosure of fees, as well as potential conflicts of interest in connection with derivatives transactions. These are not retail transactions. They are institutional transactions between sophisticated parties that are well equipped to negotiate and have considerable bargaining power in a competitive market. In this context, highly specific disclosure rules are unnecessary and could constitute significant new and unnecessary impediments to economically useful transactions that are beneficial for end users.

In addition, SIFMA members are concerned about the imposition of new capital requirements with respect to their cleared swaps. The clearing process makes these transactions less risky because it provides a well-capitalized clearinghouse as a counterparty. The clearinghouse's requirement that all of its transactions be secured by margin also reduces risk. The addition of a further safeguard by imposing the requirement of incremental capital for cleared transactions is unnecessary and unwise, in particular because the cost of each of these layers of protection is directly borne by the dealers and ultimately by their customers. Policymakers should be careful about increasing the cost of these transactions, because doing so may discourage their use for risk management purposes. Giving the CFTC, the SEC, and prudential regulators the general authority to establish appropriate capital requirements would seem to be enough.

The provisions of the Act regarding security-based swaps are another aspect of the proposed legislation that we believe could be improved by taking a different approach. The Act gives the SEC jurisdiction over security-based swaps, in part, by amending the Securities Act of 1933 to include those products in the definition of "security," a term that is already broadly drafted and which has been broadly interpreted by our courts. This approach is expedient and straightforward, but likely would have unintended adverse consequences that would be difficult and time-consuming to resolve because many of the concepts and requirements under the federal and state securities and other laws do not readily apply to security-based swaps.

For example, under the Securities Act, the issuer of a security has certain disclosure obligations to purchasers of the security. However, swaps are bilateral contracts in which either or both parties to the contract might well be viewed as the issuer. This could lead to a number of anomalous results, including, for example, mutual simultaneous disclosure requirements for both parties. Identifying a central clearing party as the formal "issuer" for cleared swaps might solve the technical issue but would do little to advance the investor protection goals of the Securities

Act’s registration scheme. Plus, this would not work for customized, non-cleared swaps.

In addition, most state courts have assumed that the term "security" should have the same meaning under both federal and state law. Simply sweeping swaps into the definition of “security” might subject swap end-users – who are entering into swaps to hedge business risks – to blue sky filings and merit review by state securities regulators unfamiliar with derivatives. While there are certain exceptions in these state laws for various types of offerings, they are neither uniform nor drafted with swaps in mind and would need to be parsed on a state-by-state basis.

Finally, the term "security" is used in a large number of sections in the Internal Revenue Code, and an expansion of the term will result in unintended consequences. For example, the receipt of stock and securities in reorganizations under subchapter C of the Code is treated as tax-free. The broadening of the definition of "security" to include security-based swaps is clearly inconsistent with the legislative purpose and policy underlying the reorganization sections of the Code. Similar inconsistencies would arise in other laws that cover securities, such as ERISA.

A better approach to providing SEC oversight and regulation of security-based swaps would be to give the SEC broad authority to adopt regulations regarding those swaps to the extent it determines that additional measures, consistent with the regulatory framework established by the Act for other swaps, are needed. This approach would enable the SEC to address unforeseen issues raised by security-based swaps without contorting existing federal securities laws and regulations to accommodate instruments for which they were not designed.

Another aspect of the security-based swap provisions in the Act that concerns SIFMA and its members is the potential application of sections 13 and 16 of the Securities Exchange Act of 1934[4] on the basis of one or more positions in security-based swaps. These provisions of the Exchange Act serve completely different purposes, neither of which would be advanced by broadening their application in this manner. Section 13 is intended to alert the market to accumulations of stock that might indicate a potential shift in corporate control. Entering into a security-based swap does not, in itself, give a party to that swap the rights of a shareholder (such as the right to vote) and as such creates no potential for a change in control. If public disclosure of large net equity swap positions is thought necessary for some other reason, that disclosure could be accomplished by creating a specific requirement that would be directly applicable to such swaps, rather than inappropriately applying section 13.

[4] Section 13 requires public disclosure by owners of more than 5% of a class of a company's equity securities. Section 16 provides that profits realized by corporate insiders, including owners of more than 10% of a class of a company's equity securities, from purchases and sales of a company's stock within a six-month period inure to the benefit of the company.

Section 16 is intended to address unfair trading by corporate insiders who by virtue of their insider status are deemed to have special access to information about the company. But because a party to a security-based swap does not thereby gain the rights of a shareholder, there is no reason to assign insider status on the basis of one or more of such swaps. Doing so would serve no useful purpose and likely prevent swap dealers and other parties from entering into economically useful transactions that rely on the availability of such swaps, including transactions that enable corporations to raise additional capital.

Finally, we have practical concerns about the short implementation time provided in the Act and about the severe constraints on the SEC's and CFTC's exemptive authority. The Act's provisions generally would become effective 180 days after the date of enactment. We do not believe this would give derivatives dealers and other market participants sufficient time to comply with the Act's complex and far-reaching provisions. We believe that the effective date for the various provisions in the Act should be no less than one year after the date of enactment. Also, as with much other legislation, the Act will have unintended consequences, some of which may be adverse, for dealers, end users, and other market participants, including state and local government and not-for-profit end users. Rather than having to pass legislation to address such consequences each time they arise, we believe it would be much more practical and beneficial to grant the CFTC and SEC exemptive authority so long as they consult with each other and with the Treasury Department and make a determination that the exemption is consistent with the purposes of the Act.

In conclusion, Mr. Chairman, I would like to emphasize that SIFMA and its members support legislation to address weaknesses in the current regulatory framework for derivatives transactions. The events of the past year have made it clear that improvements are needed. However, the use of derivatives has become an integral part of our economy because they enable end users, including most of our country's leading non-financial corporations, to effectively manage risk, and most have done so without creating new risks or adverse consequences. As such, it is important that legislation intended to improve derivatives regulation and reduce systemic risk does not unnecessarily impair the usefulness of derivatives and thereby increase risk exposure of the many companies that have come to depend on them.