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U.S. SECURITIES AND EXCHANGE COMMISSION

REMARKS BEFORE THE

AMERICAN STOCK EXCHANGE

14TH ANNUAL OPTIONS AND DERIVATIVES COLLOQUIUM

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* The views expressed herein are those of Commissioner Beese and do not necessarily represent those of the Commission, other Commissioners, or the staff.

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REMARKS OF J. CARTER BEESE, JR.
BEFORE AMEX

Over the past two years, derivatives have been generating and receiving an increasing amount of attention from regulators and legislators around the world. What started out as an inquiry to determine what was going-on, is quickly becoming an exercise in deciding what must be done next. Though we can debate for hours what, if any, additional regulation or legislation is needed, I am certain about one thing: in today's international financial markets, there is no such thing as a quick fix or an easy solution. In fact, while some solutions may initially have some appeal, their long term effect can be devastating.

One need only to look to the Swiss experience a few years ago to see the danger of short-sighted government policies in today's inter-linked global capital markets. Seeking an additional source of revenue, Switzerland imposed a stamp tax on securities transactions.

The net result? Its eurobond business moved to London, and its mutual fund business to Luxembourg. Belatedly, the Swiss partially repealed this tax last April. However, their eurobond business is now firmly entrenched in London, and seems unlikely to return. The prognosis for their mutual fund business is no better.

Although the Swiss are taking other steps to lure business back to their country, the damage from the government's policies has been done.

The moral of this story is simple, and is as true for countries with the largest financial markets as it is for those with the smallest: in an environment in which capital knows no borders, and billion dollar deals are consummated at the stroke of a computer key, regulators around the world now have another challenge to deal with: regulatory arbitrage.

Regulators no longer have the luxury of simply regulating things we don't like out of existence. Today, more than ever, the instrument or practice we seek to ban all too easily simply finds a more sympathetic market, off-shore, out of our direct reach. But out of sight is not out of mind. The practice or instrument may be geographically removed, but the systemic risk remains in our markets.

Today, designing a regulatory framework for derivatives and other new instruments is one of our most difficult tasks. How we answer this call, and how you, as market participants, address these same summons, will shape the face of our markets for years to come.

Just last week, the SEC took another significant step in its efforts to construct a viable approach to derivatives regulation within a global setting. Together with the CFTC and the British counter-part to the SEC, the Securities and Investments Board (SIB), we issued a Joint Statement establishing an agenda for oversight of the OTC derivatives market.

The Joint Statement is noteworthy for several reasons. This is the first international understanding among regulators that outlines an approach to what is truly an international market. While many informal groups of international regulators in both the banking and securities industries have met to discuss the regulatory concerns presented by the explosive growth of the OTC derivatives market, this statement marks the first time that the regulators have formally set out the goals they hope to achieve.

Some of the goals are regulatory in nature. For example, the three agencies have agreed to enhance the existing arrangements for the exchange of financial and operational information regarding the major securities and futures firms they each regulate. The motivating force behind this arrangement is simple: you can't effectively regulate what you don't know. If the goal is to address the potential for systemic risk, we must first know its source and its size.

This is not an open-ended agreement, however. The agencies will share information when either 1) a defined triggering event occurs, such as a U.S. firm providing a required notice to its SRO or primary regulator that their net capital levels are below the minimum required amount, or (2) upon request, if reasonable grounds exist that the financial or operating condition of a firm may be materially affected by a regulated entity. In other words, there has to be some reason to exchange the information, not just idle curiosity.

Another regulatory goal is the establishment of capital standards that encourage incentives for good risk management. The agencies are continuing to review and modify, as appropriate, their capital standards, in hopes of creating prudent risk-based charges for firms.

This certainly is an area where the SEC has been very active, and you can expect that we will continue to be very active.

This trend started last May, when the SEC asked for public comment on a broad range of issues relating to the appropriate capital treatment of derivative products under the Commission's net capital rule. Last week we also proposed amendments to the net capital rule to allow broker-dealers to use option pricing models to determine haircuts for listed options and related positions. The amendments represent a switch to the more sophisticated portfolio approach to calculating capital.

Under the amendments, however, brokers and dealers wishing to do so could continue to compute haircuts under the strategy-based rules similar to those currently in force. There is a sixty day comment period, so I urge you those of you wishing to comment to obtain a copy of the release and let us hear from you.

These amendments are just the first of several steps to update and revise the net capital rule and to provide for prudent levels of capital consistent with current derivatives activity. At the same time we have these new haircut rules out for comment, we also are considering for the first time how to incorporate OTC options into the pricing model strategy. Obviously, this is a much more difficult job, as OTC options often lack the same degree of information regarding pricing and liquidity that are the requisite model inputs.

The next planned step will be for the Division of Market Regulation to establish market risk charges for interest rate swaps, and after that, to tackle currency exchange agreements. The goal is to have proposals out for comment in each of these areas by the end of summer.

In a related area, the Joint Statement also addressed netting arrangements, and their impact on capital standards. Legally enforceable netting arrangements are of vital importance to market participants trying to control and manage their counterparty credit exposure. Credit risk can be just as dangerous as market risk. The agencies agreed that applicable capital standards should reflect the risk-reducing characteristics of legally enforceable netting arrangements.

In addition to these regulatory goals, the Joint Statement also addressed what I term as market or industry goals. Among these goals are the desire to promote the development of sound management controls, to encourage greater standards for customer protection, to improve accounting and disclosure standards and to establish a framework for multilateral clearing arrangements.

The Joint Statement reflects the extraordinary efforts that international regulators have undertaken to address common concerns. But domestic regulators have also been engaged in a coordinated and cooperative effort to strengthen our nation's capital markets. Since Gerry Corrigan sounded his initial warning, representatives of the Board of the Fed, the CFTC, the Treasury, the SEC and the New York Fed have met regularly to discuss derivatives regulation as part of the Working Group on Financial Markets. To the extent that Mr. Corrigan identified gaps in the regulatory system, I believe that we are moving forward to close them.

For example, much like the parties to the Joint Statement, the Working Group is quite concerned about enhancing the disclosures available for dealers and end-users both in the U.S. and abroad. Moreover, The Working Group is also attempting to devise a uniform international format for reporting derivatives activity to regulators. I applaud these efforts. I have long believed that the more information we have, the better we will understand this market, and the more effective our regulatory efforts can be.

In fact, the SEC's efforts to gather information as part of our Risk Assessment program has worked out well, and we will consider refining these rules to make them even more efficient sometime later this year.

Finally, the Working Group is also concentrating on internal controls for the different types of dealers present. Historically, bank supervisors looking at banking institutions have had different concerns than securities regulators looking at securities firms. With both entities now actively participating in the same market, it makes sense for the regulators to get together and compare notes and see how their requirements stack up against other objective standards, such as those contained in the Group of 30 Report.

This concern over internal controls highlights the fact that the industry goals established by the Joint Statement are fundamentally different from the regulatory goals. Indeed, the more I think about regulating derivatives, the more I believe that the industry and the market participants hold the key to meeting the concerns that have prompted the regulators to call for action in these areas.

Unfortunately, the private sector may be facing a time limit for its response. In addition to regulators, Congress is quite concerned about many of these same topics, and how quickly and how responsibly you act may eventually determine how and if Congress acts.

Of course, many have questioned whether Congress will act on derivatives legislation. This year, I believe that a number of forces are conspiring to force Congress' hand.

First, the financial press is starting to report instances of billion dollar losses related to derivatives usage at companies such as Metallgesellshaft and a Japanese subsidiary of Shell Oil. While we can debate the causes of these losses, some have laid the blame squarely at the feet of management and the Board of directors for failing to have adequate risk management systems in place. There can be little doubt that the best way to control systemic risk is for every market player to control risk at the firm level. That is why the Joint Statement spotlights this issue, and the agencies involved are committed to working with industry groups to improve systems for monitoring and controlling derivatives activities.

But as more instances of huge losses gain attention, Congress will feel more pressure to act. Although none of the spectacular losses thus far have caused any systemic problems, we must remember that these losses have occurred in relatively stable markets. What happens when such a loss occurs in a volatile market is certainly a question that politicians, as well as regulators, must ponder.

Second, the environment on Capitol Hill is still clouded by the lingering effects of the S&L debacle. Having failed to predict one financial disaster, many are eager to be on record about their views on derivatives. The GAO report will be the lightning rod for these prognosticators. From what I have heard, the GAO report will be tough and err on the side of prudence, with the end result being a call for legislation. A GAO staffer was recently quoted in Institutional Investor stating that he hoped the report ".. doesn't drop a bomb on the world, but it is possible."

With health care, welfare reform and other big issues demanding members' attention, there is the chance that no legislation will be passed this year. Chairman Dingell of the House Energy and Commerce Committee said as much this week. On the other hand, faced with a GAO study calling for legislation, Congress will be hard pressed not to act. My sense is that legislation will go forward, and the issue to consider is what shape that legislation will take.

Representative Leach's bill has already been introduced, and his proposals represent a modest approach. The danger is that with three House Committees having jurisdiction, along with two from the Senate, significant turf issues may cloud the debate. What any legislation will look like is difficult to predict, but if a crisis or more accidents along the lines of Metalgesellschaft or Gibson Greetings erupts, rapid-fire legislation may be the ultimate result.

The industry could mitigate against this possibility by taking greater steps now to self-police and self-discipline market participants. Reading between the lines of the Joint Statement, I think it is fair to say that the SEC is committed to following up with the appropriate SRO's to see if some type of industry code of conduct is feasible, as others have suggested. Clearly, we are concerned about suitability and whether the "know thy customer" rule is being applied in the derivatives marketplace. If the industry moves forward to address these concerns, then both Congress and the SEC will have less to worry about.

Similarly, the Joint Statement also calls for the consideration of a regulatory framework to apply to clearinghouses and other multilateral arrangements OTC derivatives transactions. This represents another area where the industry can act and suggest a solution, rather than re-act to a government requirement.

Finally, the industry could go a long way to helping its cause by de-mystifying some of the accounting and disclosure practices currently prevalent in the business. I realize that the international accounting standard-setting bodies control your destiny somewhat, but efforts to make certain practices more uniform would be greatly appreciated.

Conclusion

As the Joint Statement demonstrates, regulators around the world are using every available avenue -- whether formal, such as the Working Group on Financial Markets, or informal, such as working with the SIA Capital Committee -- to seek out the best possible coordinated regulatory solution to the challenges presented by the explosive growth of the derivatives markets.

But regulation should exist primarily to set a floor as to which types of activities are not acceptable. To the extent that the marketplace can discharge this function itself, the need for regulation or even legislation will be lessened.

If anything, recent events have shown that heavy-handed government intervention intended to solve problems frequently works -- but only by erecting regulatory barriers so high as to significantly affect competitiveness. For example, just last year Japanese regulators tried to ban arbitrage and proprietary trading in stock-index futures if, in their opinion, the futures market became overheated. Just suggesting these new rules caused many traders to start looking to the Singapore International Monetary Exchange, or SIMEX, as an alternative place to trade Nikkei 225 stock index futures, which trade in Japan on the Osaka Securities Exchange.

In an article yesterday, the Financial Times reported that the SIMEX's second-largest contract is now the Nikkei 225, with the volume growing at the expense of the of the Osaka exchange. Moreover, the article noted that the higher margins and larger commissions found in Japan also made the SIMEX a cheaper and more attractive market.

If Japanese regulators overseeing the world's second-largest stock market have difficulty keeping trading on-shore, surely the U.S. financial markets are not immune. Rather than fighting the market forces we face, and driving more trading outside of our supervision, we need to explore market-oriented solutions that work best for investors. As the Swiss are finding out the hard way, it is preferable to maintain financial markets, rather than re-build them.

Today, we can make a good case that if the private sector acts to address derivatives issues, legislation written in statutory stone may not be needed. But once the GAO report comes out, the tenor of this debate will change for everyone. With Congress and the SEC looking over your shoulder, I respectfully suggest that the time to act is now.