

MEMO# 6569

January 17, 1995

CONGRESSMAN LEACH INTRODUCES DERIVATIVES LEGISLATION

January 17, 1995 TO: INVESTMENT ADVISERS COMMITTEE No. 5-95 SEC RULES COMMITTEE
No. 7-95 RE: CONGRESSMAN LEACH INTRODUCES DERIVATIVES LEGISLATION

Congressman
James Leach (R-IA), Chairman of the House Banking Committee, recently introduced the "Risk Management and Derivatives Oversight Act of 1995." If enacted in its current form, the bill could apply to investment companies and investment advisers that invest in derivatives. A copy of the bill is attached and it is briefly described below. Title I of the bill calls for the formation of a Federal Derivatives Commission ("Commission"), to "establish principles and standards to improve risk management and the prudent use of derivative financial instruments by financial institutions." "Financial institutions" are defined in the bill to include, among other things, any type of end-user of derivatives, as determined by the Commission. The bill specifies that the Commission would be chaired by the Chairman of the Board of Governors of the Federal Reserve System, and in addition would consist of the Comptroller of the Currency, the Chairman of the Board of the FDIC, the Director of the Office of Thrift Supervision, the Chairman of the CFTC, the Chairman of the SEC and the Secretary of the Treasury. Under the bill, each appropriate regulatory agency would be required to adopt "substantially similar" regulations to implement the principles and standards established by the Commission, absent a finding that such adoption is not necessary or appropriate in the public interest. The bill would direct the Commission to consider making recommendations for financial regulators to take comparable regulatory action on the need to establish principles and standards in several areas, including enhanced risk disclosures to investors in mutual funds that invest in derivatives. Other areas for consideration include: (1) capital requirements; (2) comprehensive risk management systems; (3) joint regulatory examinations by the federal banking agencies of "insured depository institutions that are derivatives dealers and any affiliates;" (4) management supervision and board oversight of derivatives activities; (5) prudent use of collateral; (6) "stress testing;" (7) appropriate credit risk reserves; (8) protection against legal risk; (9) minimum prudential practices for municipalities and pension funds that may use derivatives; and (10) assurances that ("consistent with safe and sound banking practices") an institution does not engage in inappropriate derivatives activities. Other functions of the Commission would include, for example, (a) encouraging foreign governments, central banks and regulatory authorities to work toward maintaining or adopting comparable supervisory standards and regulations for financial institutions engaged in derivatives activities; and (b) sponsoring training programs on derivatives for regulatory agency and financial institution employees. Title II of the bill provides, among other things, that the "[f]ailure of an institution- affiliated party engaged in derivatives activities to have adequate technical expertise may be deemed to constitute an unsafe or

unsound banking practice" under the Federal Deposit Insurance Act. The scope of the term "institution-affiliated party" is not clear. This title also establishes requirements concerning reporting of information concerning derivatives activities to the appropriate regulators when they determine that such information is needed as a result of adverse market conditions or other emergency situations. Title III of the bill, entitled "Financial Institution Insolvency Reforms," seeks to provide certainty as to the status of and rights of parties to certain "qualified financial contracts" (as defined under the Federal Deposit Insurance Act) in the event of the insolvency of an insured financial institution acting as a counterparty. Under Title IV of the bill, the Federal Reserve Board would be authorized to establish a self-regulatory association for derivatives dealers, after considering certain specified factors. A "derivatives dealer" is defined as "any financial institution that is engaged in the business of brokering or dealing in 'derivative financial instruments,'" as determined by the Board. Excluded from the definition is any person registered as a broker or dealer of securities or as a futures commission merchant. The term "financial institution" is defined in this title of the bill to include "any ... institution that the Board determines to be a financial institution." Although this title presumably is aimed at unregistered broker-dealer affiliates that act as dealers of OTC derivatives, as drafted the scope of these provisions is unclear. Please review the attached bill and contact me at (202) 326-5822 by Wednesday, February 1 with any comments about problems the proposed legislation might cause for investment companies or investment advisers. Frances M. Stadler Associate Counsel Attachment