

**MEMO# 6620**

February 2, 1995

## **CONGRESSMAN GONZALEZ INTRODUCES DERIVATIVES LEGISLATION**

1 See Memorandum to Investment Advisers Committee No. 5-95 and SEC Rules Committee No. 7-95, dated January 17, 1995. February 2, 1995 TO: INVESTMENT ADVISERS COMMITTEE No. 9-95 SEC RULES COMMITTEE No. 16-95 RE: CONGRESSMAN GONZALEZ INTRODUCES DERIVATIVES LEGISLATION

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Congressman Henry Gonzalez (D-TX), the Ranking Minority Member of the House Banking Committee, recently introduced H.R. 31, the "Derivatives Safety and Soundness Supervision Act of 1995." The bill, which is summarized below, is similar in many respects to the proposed derivatives legislation introduced by Congressman Leach that previously was circulated to you.<sup>1</sup> Unlike the Leach bill, however, the Gonzalez bill expressly would cover investment companies and investment advisers. A copy of H.R. 31 is attached. Title I of the bill would require the "appropriate Federal regulatory agencies" (defined to include, among others, the federal banking agencies, the SEC, the CFTC, the Federal Reserve Board and the Treasury Secretary) to consult with each other and establish "substantially similar standards" with respect to capital, accounting, disclosure, risk management and suitability in connection with the supervision of "financial institutions" engaged in "derivatives activities." "Financial institutions" are defined to include investment companies and investment advisers, among other entities. "Derivatives activities" include activities in which a financial institution is engaged as an "active end-user," which in turn is defined to mean a financial institution that "buys or sells a significant amount of derivative financial instruments, or conducts transactions in a wide variety of derivative financial instruments." The bill lists certain factors to be considered, in establishing the new regulatory standards referred to above, that are largely identical to those included in the Leach bill. One notable exception is that the Gonzalez bill, in contrast to the Leach bill, would not require consideration of the need for enhanced risk disclosures to investors in mutual funds that invest in derivatives. The bill would authorize federal bank regulators to require insured depository institutions to disclose in call reports certain quantitative and qualitative information concerning derivatives, and would authorize other federal regulators to adopt similar quarterly reporting requirements for "financial institutions" that are not insured depository institutions. Title II of the bill would prohibit a "financial institution" from engaging in derivatives activities unless it has in place a written management plan approved by the board of directors which, among other things, ensures that the activities are "conducted in a safe and sound manner" and establishes prudential standards for the management of the risks involved in such activities and a framework for internal controls with respect to such activities. It would require that the directors of a "financial institution" be informed of the risks associated with the institution's derivatives activities and the "total current credit exposure" of the institution with respect to such activities. Similar to the

Leach bill, the Gonzalez bill includes a provision specifying that the failure of an "institution-affiliated party" engaged in derivatives activities to have adequate technical expertise with respect to such activities may be treated by the appropriate Federal regulatory agency as an unsafe or unsound practice in conducting the business of the institution. In addition, like the Leach bill, the Gonzalez bill provides for confidential reporting of information about derivatives activities to regulators in the case of adverse market conditions or other emergency situations. Title III of H.R. 31, like Title III of the Leach bill, is designed to clarify the status of and rights of parties to certain derivative financial instruments in the case of the insolvency of an insured depository institution that is acting as counterparty. The Gonzalez bill also would require a study of international regulation and supervision of derivatives activities of financial institutions (led by the Secretary of the Treasury) and encouragement of international negotiations to work towards maintaining and adopting comparable supervisory standards and regulations. In addition, the GAO would be required to undertake a study of "the speculative uses of derivative financial instruments by financial institutions and the feasibility of imposing margin and collateral requirements on speculative transactions engaged in by financial institutions which involve derivative instruments." It is anticipated that the House Banking Committee will schedule hearings on derivatives legislation although it is not clear when. If you have any comments on the attached bill, please call me at (202) 326-5822 by Wednesday, February 15th. Frances M. Stadler Associate Counsel Enclosure