TESTIMONY OF

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COMMODITY FUTURES TRADING COMMISSION

CONCERNING LONG-TERM CAPITAL MANAGEMENT

BEFORE THE U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON

BANKING AND FINANCIAL SERVICES

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Mr. Chairman and members of the Committee, thank you for providing me an opportunity to testify concerning Long Term Capital Management (LTCM) and its financial difficulties. This episode should serve as a wakeup call about the unknown risks that the over-the-counter (OTC) derivatives market may pose to the U.S. economy and to financial stability around the world. It has highlighted an immediate and pressing need to address whether there are unacceptable regulatory gaps relating to hedge funds and other large OTC derivatives market participants. The Commodity Futures Trading Commission (Commission or CFTC) is currently studying these issues as announced in its May 12, 1998 Concept Release on OTC Derivatives and as I testified before this Committee in July of this year.[1]

I welcome the heightened awareness of these issues that the LTCM matter has engendered and believe it is critically important for all U.S. financial regulators to work together closely and cooperatively on them. Therefore, I applaud Secretary of the Treasury Robert Rubin's call for a meaningful study by the President's Working Group on Financial Markets and look forward to working with him and the other members of the Working Group. Swift regulatory responses may well be needed to protect the U.S. and world economy.

LTCM is a hedge fund, a speculative investment vehicle for very wealthy and sophisticated investors. Because LTCM trades on U.S. futures and option

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1 Testimony of Brooksley Born, Chairperson, CFTC, before the U.S. House of Representatives Banking and Financial Services Committee, July 24, 1998 (attached hereto as Exhibit 1). The Commission's Concept Release on OTC Derivatives, 63 Fed. Reg. 26114 (May 12, 1998), is Attachment 1 to that testimony.

exchanges, it is registered with the CFTC as a commodity pool operator (CPO). To the best of my knowledge, it is not subject to oversight by any other federal agency.[2]

Pursuant to CFTC requirements that large traders' positions must be reported on a daily basis, LTCM's positions on U.S. futures exchanges have been reported daily to the CFTC, and both the CFTC and U.S. futures exchanges have had full and accurate information about LTCM's on-exchange futures positions. Moreover, LTCM has been promptly and fully paying margin on its futures positions, which are marked to market daily. However, neither the CFTC nor the U.S. futures exchanges had information on LTCM's position in the OTC derivatives market since no reporting of that information is routinely required.

On Wednesday, September 23, 1998, the Department of the Treasury informed the Commission that LTCM was in financial difficulty. Press reports state that its capital at that time had dipped below $1 billion. However, it had reportedly been able to leverage that capital to invest in securities valued at as much as $125 billion. It had also reportedly entered into derivatives contracts with a notional value of $1.25 trillion. Most of these derivatives were reportedly OTC swap transactions, while the rest of LTCM's derivatives position consisted of exchange-traded futures on domestic and foreign exchanges.

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[2] As a CPO, LTCM is subject to registration, certain recordkeeping and reporting requirements and fraud prohibitions under the Commodity Exchange Act (CEA) and the Commission's regulations. Since hedge funds like LTCM are offered only to financially sophisticated investors, they are exempted from certain CPO disclosure requirements relating to communications with those investors. A memorandum entitled "CFTC Regulation of Hedge Funds and Commodity Funds," prepared by Commission staff, is attached hereto as Exhibit 2.

Evidently because of concern that LTCM was about to default on margin calls on its enormous derivatives position and other loans, LTCM's largest creditors--some of the largest U.S. and European commercial banks and the largest U.S. investment banks--reportedly have agreed to contribute about $3.6 billion in capital to LTCM and to take a 90% ownership interest in LTCM. Many of these creditors were reportedly LTCM's swaps counterparties.

After learning of LTCM's difficulties, the Commission staff quickly determined the nature and value of the positions the firm carried on U.S. futures exchanges and took steps to identify and address any dangers to the exchanges and their clearing houses resulting from LTCM's problems. The Commission staff analyzed its large trader reporting data and instituted an immediate special audit of LTCM and inspected its accounts at the U.S. futures commission merchants (FCMs) that carried and cleared LTCM's exchange-traded futures transactions. We immediately contacted senior officials of the U.S. futures exchanges on which LTCM held positions and certain international regulatory authorities to alert them about possible problems related to LTCM's derivatives positions. We also contacted the National Futures Association (NFA), the registered futures association which has delegated authority from the Commission to oversee CPOs and CTAs such as LTCM, and have coordinated with NFA in the special audit of LTCM. Our staff continues to monitor the situation closely and to verify that LTCM and its clearing FCMs can meet their margin requirements on U.S. futures exchanges. Commission staff is also exploring whether any laws or regulations have been violated. We have been in close communication on the LTCM matter with other members of the President's Working Group on Financial Markets.

The Commission staff is taking steps to try to identify other traders whose positions in the OTC derivatives market may affect our regulated markets or financial stability. For example, we are currently seeking information about other large hedge funds that are registered as CPOs. We are in contact with large FCMs, futures exchanges and the NFA to insure that they pay particular attention to these issues and that they report unusual activity to the Commission.

Moreover, the Commission is examining the CEA and the Commission's regulations on CPOs and CTAs to determine whether improvements are necessary. As noted above, the Commission is continuing its ongoing study of the OTC derivatives market and the adequacy of its current regulations relating to that market and its participants.

Since its recapitalization, LTCM has continued to meet its margin calls on U.S. futures exchanges, and I hope that the arrangement with its creditors will prove to be successful. Because of the lack of any reporting requirements concerning OTC derivatives positions, it is unknown whether other hedge funds or large OTC derivatives market participants pose dangers to the economy.

What is clear is that the LTCM events raise a host of important issues relating to hedge funds and to the increasing use of OTC derivatives by those funds and other institutions in world financial markets. Most of these issues were raised by the Commission in its Concept Release on OTC Derivatives and are currently being studied by the Commission. These issues include the following:

1. Lack of Transparency

While the CFTC and the U.S. futures exchanges had full and accurate information about LTCM's on-exchange futures positions, no federal regulator received reports from LTCM on its OTC derivatives position. Indeed, no reporting requirements are imposed on most OTC market participants. This lack of basic information about the positions held by OTC derivatives users and the nature and extent of their exposures potentially allows OTC derivatives market participants to take positions that may threaten our regulated markets or, indeed, our economy without any federal agency knowing about it. Furthermore, there are no requirements that a hedge fund like LTCM provide disclosure documents to its investors or counterparties concerning its positions, exposures or investment strategies. A hedge fund's derivatives transactions have traditionally been treated as off-balance sheet transactions, so even the annual financial reports filed with the Commission do not fully reveal its positions.

The OTC derivatives market has little price transparency, unlike regulated futures exchanges where bids and offers are quoted publicly and positions are marked to market daily. Lack of price transparency may aggravate problems arising from volatile markets because traders may be unable accurately to judge the value of their positions or the amount owed by their counterparties. Lack of price transparency also may contribute to fraud and sales practice abuses, allowing OTC derivatives customers to be misled as to the value of their interests.

As the Commission has suggested in its Concept Release, questions about the need for reporting, recordkeeping, disclosure and price transparency in the OTC derivatives market should be addressed.

2. Excessive Leverage

While traders on futures exchanges must post margin and while their positions are marked to market on a daily basis, no such requirements exist in the OTC derivatives market. LTCM reportedly managed to borrow so much that it was able to hold derivatives positions with a notional value of as much as 1300 times its capital. A hallmark of LTCM's OTC derivatives transactions apparently has been the firm's insistence that it would never provide its counterparty with any initial margin. Its swaps counterparties reportedly did not have full information about its extensive borrowings from others and therefore unknowingly extended enormous credit to it. This unlimited borrowing in the OTC derivatives market--like the unlimited borrowing on securities that contributed to the Great Depression--may pose grave dangers to our economy.

The Commission's Concept Release describes many of the risk-limiting procedures and requirements employed in the regulated futures markets--including mutualized clearing arrangements, margin requirements, capital and audit requirements--and calls for comment on whether similar requirements are needed in the OTC derivatives market. It is essential to consider how to reduce the degree of leverage in the OTC derivatives market and the attendant risks.

3. Insufficient Prudential Controls

Closely related to the issue of excessive lending to LTCM is the apparent insufficiency of the internal controls applied by the firm and its lenders and counterparties. In its Concept Release, the Commission calls for comment on a number of issues relating to the sufficiency of internal controls and risk management mechanisms employed by OTC derivatives dealers and their customers, including VAR models. Such issues should be addressed.

4. Need for a Coordinated International Approach

International regulators have expressed concern for some time about the lack of effective oversight of hedge funds and other large users of OTC derivatives and their ability to avoid regulation by any one nation in their global operations. Indeed, several emerging market countries have attributed crises in their currencies and markets to the actions of large hedge funds. The LTCM situation presents a new opportunity for the Commission and other U.S. regulators to work with regulatory authorities in other countries to harmonize regulation of the OTC derivatives market and its participants and to implement international regulatory standards.

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Despite the immediate and pressing need to address these and related regulatory issues, Congress is about to restrict the Commission in doing so. Congress is about to adopt the so-called "Financial Markets Reassurance Act of 1998," which was attached to the agriculture appropriations bill in Conference

Committee earlier this week. That bill would prohibit the CFTC from proposing or adopting any new regulations relating to OTC swaps transactions until March 30, 1999, except in limited circumstances. The CFTC is currently the only federal agency with statutory authority over hedge funds like LTCM and over a significant portion of the swaps market. To tie its hands during this time of economic instability and growing awareness of the potential dangers in the swaps market could pose grave risks to the American public.

Thank you. I would be pleased to answer any questions members of the Committee may have.