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Report to the Chairman, Subcommittee on Capital Markets, Securities and GSEs, Committee on Banking and Financial Services, House of Representatives

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FINANCIAL REGULATORY COORDINATION

The Role and Functioning of the President's Working Group

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The Honorable Richard H. Baker
Chairman, Subcommittee on Capital Markets, Securities
and GSEs
Committee on Banking and Financial Services
House of Representatives

Dear Mr. Chairman:

As you requested, this report discusses the role and functioning of the President's Working Group on Financial Markets (Working Group). Following the highly publicized losses experienced by a large leveraged hedge fund[1] in 1998 and the potential implications for worldwide financial markets, questions began to surface about the role and functioning of the Working Group. This group includes the Secretary of the Treasury (Treasury) and the chairs of the Board of Governors of the Federal Reserve System (Federal Reserve), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC). Although the Working Group was initially established by Executive Order 12631,[2] in response to issues surrounding the 1987 stock market crash, since 1994 it has served as a mechanism to coordinate regulatory responses to various market events that have arisen. Our objectives were to determine (1) whether the issues listed for consideration by the Working Group in the executive order have been considered, (2) what additional issues have been considered by the Working Group and how they were identified, and (3) the nature of coordination and cooperation within the Working Group and the views of Members of Congress and Working Group participants about whether it needs to be formalized in statute.

Results in Brief

The Working Group and the relevant agencies have considered the issues articulated in the executive order concerning the 1987 market crash. The 29 issues were divided among four categories (1) investor confidence, (2) the credit system, (3) market mechanisms, and (4) the financial regulatory

[1]Although there is no statutory definition of hedge funds, it is the term commonly used to describe private investment vehicles that often engage in active trading of various types of securities and commodities. Although some funds are subject to certain federal reporting requirements, hedge funds are generally exempt from direct federal regulation.

[2]Executive Order 12631 of March 18, 1988, 3 C.F.R. 559 (1989), Working Group on Financial Markets.

structure. All of the issues were discussed in the Working Group's 1988 report[3] on the market crash, or subsequently were addressed by SEC, CFTC, or the exchanges they regulate. Since 1994, the Working Group, the agencies, and the exchanges have continued to review some of the issues raised by the 1987 market crash. The Working Group and the agencies also have revised a few of its May 1988 recommendations, such as the 1998 revision of coordinated trading halts, or "circuit breakers,"[4] and expansion of their work on bankruptcy reform, which was raised in the group's report on the 1987 market crash.

Since 1994, the Working Group also has considered a variety of other financial issues. Most of its activities have resulted from self-initiated or congressionally requested work following some market event or issue. For example, following the 1997 market disruption that triggered circuit breakers,[5] the Working Group began studying the need for modifications to existing provisions.[6] This study resulted in a letter to the New York Stock Exchange (NYSE) that recommended a change in the basis for circuit breakers from a point decline in the Dow Jones Industrial Average (Dow) to a percentage decline in the Dow.[7] The Working Group has also drafted legislation aimed at reforming provisions of the Bankruptcy Code that apply to certain types of financial instruments. Members of Congress have also asked the Working Group to examine issues involving hedge funds, Year 2000 (Y2K) preparedness issues, and over-the-counter (OTC) derivatives[8] oversight. The Working Group addressed these issues in April 1999,[9] September 1999,[10] and November 1999,[11] respectively.

[3]Interim Report of The Working Group on Financial Markets, (May 1988), President's Working Group on Financial Markets.

[4]Circuit breakers are coordinated trading halts in the equity and equity-derivative markets that are required when large price moves of predetermined magnitude occur.

[5]On October 27, 1997, at 2:35 p.m., the 30-minute circuit breaker was triggered when the Dow dropped 350 points. When the market then reopened at 3:05 p.m., the second circuit breaker was tripped 25 minutes later when the Dow dropped 550 points, which closed the market for the rest of the day.

[6]SEC, CFTC, and the exchanges they regulate had been studying the performance of circuit breakers since 1987.

[7]Although the three triggers are stated in terms of a point decline, the trigger value is calculated at the beginning of each calendar quarter using 10 percent, 20 percent, and 30 percent, respectively, of the average closing value of the Dow for the month prior to the beginning of the quarter.

[8]Derivatives are financial instruments whose value is determined from an underlying reference rate (interest rates, foreign currency exchange rates); index (reflects the collective value of the various financial products); or assets (stocks, bonds, and commodities). Derivatives can be (1) traded through central locations, called exchanges, where buyers and sellers, or their representatives, meet to determine prices or (2) privately negotiated by the parties off the exchanges or over the counter (OTC).

Although the Working Group was established to respond to issues raised by the 1987 market crash, it currently serves as an informal mechanism for coordination and cooperation among its members and their staffs.[12] Since 1994, the members of the Working Group, or principals, have met several times a year to discuss ongoing issues and current market events. According to officials familiar with the Working Group, the frequency of its meetings usually is driven by market events. The senior staffs of the agencies, who are responsible for carrying out the work of the Working Group (the Steering Committee), generally meet biweekly. Agency officials said that meetings of the Steering Committee are informal and generally have focused on agency perspectives, market events, agency actions, and financial legislation. The agendas we reviewed provided examples of the topics the Steering Committee was to discuss in 1998 and 1999. During this time, Committee agendas focused on the group's ongoing reviews and studies of circuit breakers, hedge funds, and OTC derivatives.

Various Members of Congress have raised questions about the Working Group's ability to coordinate and function effectively. For example, following the near-collapse of Long-Term Capital Management (LTCM), a large leveraged hedge fund; questions were raised about the degree of coordination and cooperation that existed within the group before the crisis. Since 1994, various proposals have been made to provide a statutory basis for the Working Group. Although such proposals could enhance continuity, they also raise resource and structural issues. Agency officials involved with the Working Group were generally averse to any formalization of the group and said that it functions well as an informal coordinating body.

Background

The Working Group was established by an executive order in 1988, in response to the 1987 market crash. The executive order listed 29 issues that the Working Group was required to consider during the course of its review. (See app. I for a complete list of the issues it was required to consider.) Following the issuance of its report in 1988 and follow-up work in 1991, the Working Group became largely inactive until 1994 when, at the

[9]Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management, Report of the President's Working Group on Financial Markets, Apr. 1999.

[10]Response of the President's Working Group on Financial Markets to Congressman John D. Dingell, Sept. 30, 1999.

[11]Over-the-Counter Derivatives Markets and the Commodity Exchange Act, Report of The President's Working Group on Financial Markets, Nov. 9, 1999.

[12]Agency officials said that they consider the Working Group to be informal because it is not based in statute and has no statutory authority.

urging of Congress and others, it was reactivated by the Secretary of the Treasury. Since that time, its principals and a Steering Committee, consisting of senior staff of the participating agencies, have met regularly.

Creation of the Working Group

On March 18, 1988, the President established the Working Group to consider the major issues and recommendations raised by the numerous studies on the October 1987 market decline that had the potential to improve the integrity, efficiency, orderliness, and competitiveness of U.S. financial markets.[13] The group, which comprised the heads of the primary federal financial regulatory agencies, was required to provide a coordinating framework for consideration, recommendation, action, and resolution of the complex issues raised by the market crash. The Secretary of the Treasury was named as the group's chairman; and the other members, or principals, are the chairs of the Federal Reserve, SEC, CFTC, or their respective designees. Members serve in the capacity as heads of their respective agencies with no additional compensation. Treasury has provided much of the administrative support that is required for the group's functioning. However, the Working Group has no separate budget.

In addition to its official members, several other financial regulators and groups, including the Federal Reserve Bank of New York (FRBNY), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the National Economic Council, and the Council of Economic Advisors, have participated regularly in the activities of the Working Group and its Steering Committee. At various times in the past, staffs of other agencies, such as the Office of Management and Budget, Department of Labor, and the Department of Commerce, have participated in discussions.

In May 1988, the Working Group submitted to the President the Interim Report of the Working Group on Financial Markets, which contained recommendations to Congress, the federal financial regulators, the securities and futures exchanges, and the financial industry, on margin and credit systems, clearance and settlement systems, and the establishment of coordinated circuit breakers. Following the issuance of this market crash report and a 1991 review of how circuit breakers performed in 1989 when the U.S. securities market experienced volatility, the Working Group became largely inactive. According to regulatory officials, although the Working Group did not meet regularly in the early 1990s, the principals and

[13]Following the 1987 market crash, numerous studies were conducted to determine what happened, and what, if anything, could be done to avoid a recurrence. Chief among the studies were those of the Presidential Task Force on Market Mechanisms, SEC, CFTC, and our 1988 work.

agencies' staffs maintained some level of communication during this period.

Activity Resumed in 1994

Following this period of relative inactivity in the early 1990s, the Working Group was reactivated, in part, at the request of the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs. In a letter dated September 23, 1993, they requested the views of the Secretary of the Treasury on the status of the Working Group; its activities; and the adequacy of coordination among and contingency planning by, the federal financial regulatory agencies. Largely drawing from the overall goals discussed in the 1988 executive order, the letter asked whether revitalization of the Working Group would be helpful in coordinating the activities of the agencies amidst increasingly integrated global financial markets.

In early 1994, the Treasury Secretary issued a letter (1994 Bentsen letter) to the other principals to confirm that the Working Group should continue and to expand its activities. The letter noted that potential problems in financial markets may cross the current jurisdictional lines among the federal financial regulators, and it requested that the Working Group consider new developments in financial markets beyond those surrounding the 1987 market crash. The letter suggested that the group serve as a means to coordinate the policies and actions of these regulators to respond to developments and emergencies in the financial markets. Suggested issues for consideration included risks in the OTC derivatives markets and clearance and settlement systems.

Scope and Methodology

To fulfill our objectives, we determined whether the items the Working Group was required to consider in the executive order were considered. This effort included reviewing the Interim Report of the Working Group on Financial Markets (May 1988) and annual Intermarket Coordination Reports written by the constituent agencies for 1991 through 1995.[14] We also examined various other reports, articles, testimonies, and papers. Finally, we met with SEC and CFTC officials to discuss the efforts that were undertaken in response to the issues articulated in the executive order.

To determine what additional issues the Working Group has considered, we interviewed officials from Treasury, the Federal Reserve, SEC, and

[14]The reports, produced for Congress by Treasury, SEC, CFTC, and the Federal Reserve, were prepared in fulfillment of section 8 of the Market Reform Act of 1990. We reviewed only SEC's 1991 report because reports for others years were not available.

CFTC, who, among others, constitute the Steering Committee. We reviewed letters, reports, and other relevant documents produced by the Working Group since 1988. To determine the extent of coordination and cooperation within the Working Group and its Steering Committee, we met with agency officials and reviewed the agencies' Intermarket Coordination Reports, which discussed their coordination activities. We also reviewed 1998 and 1999 Steering Committee meeting agendas to determine the nature of the group's biweekly meetings. Although regulators also coordinate certain activities bilaterally and multilaterally, we focused on the activities of the Working Group (and Steering Committee). To gather information on the views of Members of Congress about the Working Group, we reviewed hearing transcripts and legislative histories. We also interviewed CFTC, Federal Reserve, SEC, and Treasury officials involved with the Working Group to obtain their views. Finally, we drew upon our relevant past work.

We requested written comments on a draft of this report from the Secretary of the Treasury and the heads of CFTC, the Federal Reserve, and SEC. Treasury provided written comments that are discusses near the end of this letter and reprinted in appendix II. CFTC, the Federal Reserve, and SEC did not provide written comments. We did our work in Washington, D.C., between March 1999 and December 1999 in accordance with generally accepted government auditing standards.

The Working Group Addressed the Issues Specified in the Executive Order

In May 1988, the Working Group issued its market crash report, which generally responded to the issues that the President required the Working Group to consider in the executive order. These issues were related to (1) investor confidence, such as the adequacy of customer protection rules and their enforcement in all markets; (2) the credit system, such as private sector credit arrangements for exchange settlement systems and market participants; (3) market mechanisms, such as revised equity short sale rules;[15] and (4) the financial regulatory structure, such as the need for a formal federal financial regulatory body to mediate intermarket issues. The report included numerous recommendations made in response to the issues listed in the executive order. Virtually all of the recommendations were undertaken by the relevant regulator, namely, SEC or CFTC and the

[15] 17 C.F.R., section 240.10a-1 (1998). Short sales involve borrowing securities and selling them in hopes of repurchasing them at a lower price at a later date. SEC's short sale rule states that a short sale can be made on a zero or plus tick.

securities and futures exchanges they regulate.[16] The issues listed in the executive order are discussed in appendix I of this report.

In addition to discussing the issues, the market crash report concluded that the Working Group could monitor the progress of its recommendations by serving as a consultative and coordinating forum and by expediting resolution of the issues that remained unresolved. Although the report recognized the need for federal financial regulatory coordination, it concluded that a more formally structured version of the Working Group was unnecessary because the current structure was sufficient.

The Working Group Has Responded to Various Market Events

The Working Group was established in response to a market event, and its subsequent activities focused on responding to market events. Since its 1994 reactivation, it has been the primary vehicle regulators have used to respond collectively to various intermarket events. Most recently, its activities have included the 1997 market decline, hedge funds and excessive leverage, Y2K preparedness issues, and the rapid growth of the OTC derivatives market.

1997 Market Decline Prompted Working Group to Recommend Changes to Circuit Breaker Rules

After the creation of coordinated circuit breakers following the 1987 market crash, the Working Group formed a staff subgroup on circuit breakers, which analyzed the regulators' review of the performance of circuit breakers during October 1989, when U.S. securities markets again experienced significant price volatility. Further, the subgroup noted that an ongoing objective for the Working Group was to assess whether circuit breakers need to be simplified and whether triggers should be adjusted and better coordinated. According to agency officials, SEC, CFTC, and the securities and futures exchanges also continued to monitor circuit breakers.

Following the October 1997 market decline when circuit breakers were triggered for the first time--10 years after the 1987 market crash--the Working Group reevaluated their use. The Working Group studied how circuit breakers performed during the 1997 market decline; and as a result of its findings, it encouraged the NYSE to revise its circuit breaker rules. The NYSE changed its rules, which had been stated in terms of a point

[16] 10 Years After: Regulatory Developments in the Securities Markets Since the 1987 Market Break, SEC, 1997.

decline in the Dow, to reflect a percentage decline in the Dow, effective April 1998.[17]

Proposed OTC Derivatives Legislation Prompted Renewed Bankruptcy Reform Activities

In its 1988 report on the market crash, the Working Group recommended that SEC and CFTC review existing bankruptcy laws and regulations to formulate a coordinated approach toward broker-dealer and futures commission merchant bankruptcies and to identify areas requiring legislative action. Although legislative changes were not made at that time, work in this area continued among the agencies. Following the group's reactivation in 1994, it proposed legislative changes to the Bankruptcy Code that would clarify the validity of netting[18] certain foreign currency transactions. A similar proposal was subsequently enacted into law.[19]

According to regulatory officials, the Working Group's efforts in this area were an outgrowth of proposed OTC derivatives legislation. The Federal Reserve and FDIC separately had been working to identify changes needed to improve the Bankruptcy Code to suit more closely modern financial contracts. Their efforts continued collectively through the Working Group in the mid 1990s. In March 1998, the group recommended that Congress enact the "Financial Institution Insolvency Laws Reform Act" (Proposal), which proposed additional changes to bankruptcy laws. Overall, the Proposal, which was crafted by the Working Group, was designed to

> "(1) clarify the treatment of certain financial contracts (i.e., securities contracts, commodity contracts, forward contracts,[20] repurchase agreements,[21] and swap agreements[22]) upon the insolvency of one of the counterparties to a transaction and (2) recognize certain netting arrangements in order to reduce the risk that the failure of one entity to pay its obligations will cause other firms to fail to meet their obligations."

[17]See, e.g., SEC Order Granting Approval of Proposed Rule Changes (submitted by various self-regulatory organizations), 63 Fed. Reg. 18477 (Apr. 15, 1998).

[18]Close-out netting provides that in the event that one or both counterparties default, the obligations between the two parties will be netted to produce a single obligation.

[19]P. L. No. 103-394, title 11, section 215 (1994).

[20]Forward contracts obligate the holder to buy or sell a specific amount or value of an underlying asset, reference rate, or index at a specified price on a specified future date.

[21]Repurchase agreements are agreements between buyers and sellers of securities, whereby the seller agrees to repurchase the securities at an agreed-upon price and, usually, at a stated time.

[22]Swaps are agreements between counterparties to make periodic payments to each other for a specified period.

The Proposal also clarified that cross-product close-out netting would be permitted under law.[23] Thus, a master netting agreement would allow obligations arising from certain financial contracts to be netted against each other. However, the Proposal maintained existing limitations on the types of entities that would benefit from the new provisions.[24]

The Working Group Responded to Issues Raised by LTCM's Near-Collapse

Following the near-collapse of LTCM and renewed concerns about the risks that hedge funds can pose to financial markets, the Working Group issued a report[25] outlining the principal policy issues raised by the episode. As indicated in our October 1999 report,[26] LTCM was a large leveraged hedge fund that lost nearly 90 percent of its capital between January and September 1998, almost rendering the hedge fund insolvent. LTCM's near-collapse raised concerns at the Federal Reserve and among its creditors and counterparties that the rapid liquidation of LTCM's trading positions and related positions of other market participants might pose a significant threat to already unsettled global financial markets. Therefore, in September 1998, the Federal Reserve facilitated a private sector recapitalization to prevent LTCM's collapse.

The Working Group released a report in April 1999 that said constraining excessive leverage was the principal policy issue arising from the events surrounding LTCM's near-collapse. The report said that constraining excess leverage not only among hedge funds but also among other financial institutions, was important to decreasing the likelihood of a general breakdown in the functioning of financial markets. The report included recommendations for improvements in several areas, such as more frequent and meaningful public disclosure, regulatory encouragement of improved private sector risk-management practices, regulatory promotion of risk-sensitive approaches to capital adequacy,

[23]On August 4, 1998, James Leach, Chairman of the House Committee on Banking and Financial Services, introduced the Proposal as the "Financial Contract Netting Improvement Act," H.R. 4239. On August 5, 1998, the House Committee on Banking and Financial Services reported a substantially similar version of the bill as H.R. 4393. Neither bill was enacted. On February 24, 1999, George Gekas, Chairman of the Subcommittee on Commercial and Administrative Law, House Committee on the Judiciary, introduced H.R. 833. Title X of H.R. 833 was very similar to H.R. 4393. As of December 31, 1999, this bill had not been enacted.

[24]The Bankruptcy Code permits only certain classes of counterparties to exercise their contractual rights under a securities contract (i.e., stockbrokers, financial institutions, or securities clearing agencies) and under a commodity or forward contract (i.e., commodity brokers or forward contract merchants).

[25]Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management, Report of the President's Working Group on Financial Markets, Apr. 1999.

[26]Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk (GAO/GGD-00-3, Oct. 29, 1999).

congressional expansion of risk-assessment rules, resolution of bankruptcy issues, and regulatory encouragement of compliance with international standards by offshore financial centers.

The Working Group Was Asked to Report on Y2K Preparedness

In May 1999, the Ranking Minority Member of the House Committee on Commerce asked the group to report on progress made on issues raised in our April 1999 report on Y2K preparedness within the financial markets.[27] In September 1999, the Working Group issued a response to this request.[28] Specifically, the group outlined work completed on (1) coordination of actions and information among regulators and other organizations during the date change period; (2) promotion of additional Y2K readiness disclosure by foreign organizations; (3) development of strategies to communicate the readiness of the financial sector to alleviate the public's concerns; and (4) identification of significant changes, if any, in the conditions reported in our April 1999 report.

The Working Group Was Asked to Report on OTC Derivatives

As mentioned earlier, the Working Group was revitalized, in part, because of concerns raised about risks posed by the rapid growth of the OTC derivatives market. In 1994, following the release of our report on OTC derivatives, Congress asked the Working Group to respond to issues raised in the report.[29] In July 1994, it issued a response and agreed to continue to discuss the issues concerning OTC derivatives. In 1998, the discussion on how to address OTC derivatives oversight continued; however, CFTC's chairperson became dissatisfied with the Working Group's progress and CFTC issued a concept release on OTC derivatives oversight as an alternative mechanism for discussion about its stance on this issue.[30] The stated purpose of the concept release was to gather "relevant data and analysis that will assist [CFTC] in determining whether its current regulatory approach continues to be appropriate or requires modification."

The concept release generated controversy among market participants and other regulators.[31] Consequently, SEC, the Federal Reserve, and Treasury

[27]Year 2000: Financial Institution and Regulatory Efforts to Address International Risks (GAO/GGD-99-62, Apr. 27, 1999).

[28]Response of The President's Working Group on Financial Markets to Congressman John D. Dingell, Sept. 30, 1999.

[29]Financial Derivatives: Actions Needed to Protect the Financial System (GAO/GGD-94-133, May 18, 1994).

[30]CFTC Concept Release concerning Over-the-Counter Derivatives, 63 Fed. Reg. 26114 (1998).

[31]Some financial regulators and market participants perceived that the paper was premised on the conclusion that many swaps are subject to CFTC jurisdiction as futures contracts and should be regulated as such.

issued a joint statement expressing deep concerns with the stance taken in the concept paper. Additionally, they drafted proposed legislation to limit temporarily CFTC's rulemaking on swaps. Similar legislation was subsequently passed,[32] and in 1998, the Working Group was asked to study OTC derivatives oversight. Issued on November 9, 1999, the resulting report examined the regulatory or legislative changes that may be appropriate to reduce systemic risk, eliminate legal uncertainty, and curtail regulatory arbitrage; it also addressed the potential use of derivatives for fraud or manipulation.

The Working Group Provides a Mechanism for Coordination and Cooperation

Agency officials involved with the Working Group generally described it as an informal mechanism that allows the free exchange of views and information on market events, proposed rulemaking or other regulatory action, and legislative developments. Their description of the group as a coordination vehicle is consistent with the stated objective in the 1994 Bentsen letter. In addition to Treasury, the Federal Reserve, SEC, and CFTC, staffs of other agencies and relevant groups were often included in the Working Group's activities. Although officials involved with the Working Group believe its current structure functions well, over the years, various Members of Congress have questioned the Working Group's ability to coordinate and function effectively. Various proposals have been made to provide a statutory basis to ensure its continuity, accountability, and effectiveness. However, these proposals also raise issues that would have to be considered, such as increased resource commitments and potential structural issues.

The Working Group Views Itself as an Informal Coordinating Mechanism

Although the Working Group is not based in statute and thus has no authority, agency officials involved with the Working Group view it as a useful mechanism that facilitates informal information sharing and coordination for various intermarket issues. In 1998, agenda items for biweekly Steering Committee meetings included decimalization of stock price quotes, Y2K initiatives, proposed revisions to the Bankruptcy Code, and circuit breakers. The 1999 agendas we reviewed were dominated by ongoing work on hedge funds and OTC derivatives oversight reports. According to agency officials, these biweekly meetings also have resulted in greater coordination among the regulators outside of the Working Group. For example, they said that a presentation at one of the Steering Committee meetings by SEC's Chief Accountant on SEC's soon-to-be released position on loan loss reserves resulted in separate discussions on the issue outside of the Working Group. The discussion was referred to the

[32]P. L. No. 105-277, Division A, title I, section 760 (1998).

Federal Financial Institutions Examination Council,[33] which held meetings with accountants from various financial regulators to discuss their differing positions on the issue. The regulators subsequently issued a joint statement "to better ensure the consistent application of loan loss accounting policy and to improve the transparency of financial statements."[34]

Agency officials described the Steering Committee's discussions as "policy-oriented." They added that although some of their activities result in tangible products, such as reports and legislative proposals, other issues are discussed on a regular basis. For example, agency officials said that they use the biweekly meetings to inform others about recent or proposed regulatory actions. In addition, some officials noted that the meetings also provide a forum to discuss upcoming hearings and share testimonies. In addition to the periodic principal meetings and biweekly Steering Committee meetings, the Working Group provides a forum to address intermarket events as they unfold. For example, agency officials said that when Barings[35] failed in 1995, the Working Group provided a forum to share information about the unfolding crisis.

Although officials generally described the Steering Committee's biweekly discussions as policy oriented, they said that they generally did not use these meetings as a forum to coordinate regulatory oversight activities of its members' agencies. Rather, they said the meetings provided a forum to alert other regulators of current events at the various agencies. For example, agency officials said that these biweekly meetings were not used to debate the merits of proposed rulemaking. Instead, agency officials often used the meetings to inform one another of agency action shortly before or after public announcements were made. When asked whether the Steering Committee was ever used as a forum to discuss potential regulatory concerns about an individual financial institution (prior to a crisis), officials said that it generally had not been used in that manner but that it could be used as such a vehicle in the future. The regulatory officials also pointed out that coordination and information sharing between the

[33]The Federal Financial Institutions Examination Council is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Federal Reserve, FDIC, the National Credit Union Administration, OCC, and OTS; it can make recommendations to promote uniformity in the supervision of financial institutions.

[34]See, e.g., SEC, FDIC, Federal Reserve, OCC, and OTS Joint Press Release OCC NR-99-65 (Joint Release, July 12, 1999); and Joint Press Release (Nov. 24, 1998).

[35]Barings Brothers & Co., Ltd., a British investment bank owned by Barings PLC, collapsed after losing over $1 billion by trading financial futures on exchanges in Singapore and Japan.

staffs of regulators occurred bilaterally and multilaterally on a "case-by-case" basis.

In recent years, because of the blurring of traditional lines that separate the businesses of banks and securities and futures firms, it is more important than ever for regulators to assess information that cuts across these lines. We addressed this issue in our report on the regulatory issues raised by LTCM and recommended that federal financial regulators develop better ways to coordinate the assessment of risks that cross traditional regulatory and industry boundaries.[36] The agencies commented that the Working Group already functions this way. However, the Working Group was established in response to a crisis and, as the need has arisen, has continued to function as such. That is, activities generally have been focused on responding to market events and developing policies to improve the functioning of markets. Generally, it has not functioned as a group for coordinating regulatory oversight, although it has discussed information sharing among agencies. The Working Group's activities generally have not included such matters as routine surveillance of risks that cross markets or of sharing information that is specific enough to help identify potential crises.[37] However, as mentioned previously, it has served as a mechanism to share information during unfolding crises.

The Working Group Also Provides a Mechanism for Members to Coordinate With Other Agencies and Groups

Staffs of nonmember financial regulators also have participated in the activities of the Working Group. According to officials, these participants take part in Working Group subgroups and contribute to its reports and other activities. For example, in the mid 1990s both the Federal Reserve and FDIC separately began to explore potential changes to the Bankruptcy Code to update laws to reflect changes in the market and better suit modern financial contracts. A series of meetings among various regulators led to the issue becoming a matter for consideration by the Working Group. FDIC, one of the nonmember participants in the Working Group, led the work on this issue and assisted in drafting the legislative proposal that suggested changes to the Bankruptcy Code to address netting certain financial products. More recently, in addition to the member agencies, OCC and FRBNY were involved in the Working Group's April 1999 report on hedge funds and its November 1999 report on OTC derivatives.

[36]GAO/GGD-00-3.

[37]Financial regulators participate in various groups that conduct surveillance of particular markets such as U.S. Treasury securities and futures markets. For example, according to regulatory officials, the staffs of CFTC, SEC, Treasury, Federal Reserve, and the FRBNY hold biweekly conference calls about financial market developments. In addition, CFTC hosts a quarterly meeting to discuss exchange-traded derivatives and related markets.

Proposals to Provide Statutory Basis for the Working Group Raise Issues of Resources and Structure

Since 1994, various Members of Congress have raised questions about the Working Group's ability to coordinate and function effectively. For example, following the near-failure of LTCM, some Members of Congress and others questioned the degree of coordination and cooperation that existed within the group prior to the development of the potential crisis. Various proposals have been made to provide a statutory basis for the Working Group, in the belief that such a basis could ensure its continuity, make it more accountable to Congress, and improve its effectiveness.

Although such proposals to provide a statutory basis for the Working Group could help ensure greater continuity and improved accountability, their impact on effectiveness could depend upon how certain issues were resolved. First, establishing the Working Group in statute and providing it with a mission would likely lead to a more formal structure than that of the current Working Group, with its informal structure and mission as articulated in the 1994 Bentsen letter. A more formal structure and more clearly articulated congressionally defined mission could provide the basis for a more focused approach to interagency coordination. However, members of the Steering Committee expressed concerns that a more formal structure could have the effect of limiting the Working Group's ability to achieve its current level of coordination, because it could lead to more bureaucracy. They believe its current structure is adequate to achieve a set of modest but realistic coordination goals.

Second, if Congress were to articulate a mission, mission requirements likely would have staff and budgetary implications. There is likely to be a correlation between the expansiveness of the mission and the resource commitment such a mission would entail. For example, certain improvements to coordination, such as greater information sharing of counterparty risk exposures across markets, could potentially be achieved with little or no additional staff or specified budget. However, more formal monitoring and sharing of routine company-level information aimed at identifying potential systemic risks could require full-time staff and other budgetary resources.

A third issue related to providing a statutory basis for the Working Group is the Working Group's lack of authority. Currently, it has no authority to bind members to its decisions or positions. Its members serve in their capacities as heads of agencies, and three of the agencies are led by commissions or a board; and thus Working Group decisions or recommendations must be approved by the respective commissions or board of the members before they can be acted upon. Formalizing the group would have little effect on addressing this issue unless legislation

provided a mechanism for making decisions binding. For example, if the group's membership were expanded to include the entire commissions and board, they may be more likely to adopt the group's decisions. However, this would raise the additional issue of making the size of the group difficult to manage.

Agency Comments and Our Evaluation

Treasury provided written comments on a draft of this report that are reprinted in appendix II. In general, Treasury raised no objections with our findings, and it reiterated that the Working Group provides a productive and valuable forum to coordinate responses, share information, and shape policy related to the financial markets.

As we agreed with your office, we plan no further distribution of this report until 7 days from its issuance date unless you publicly release its contents sooner. We will then send copies of this report to Representative Paul Kanjorski, Ranking Minority of the Subcommittee and to Senator Phil Gramm, Senator Tom Harkin, Senator Richard Lugar, Senator Paul Sarbanes, Representative Tom Bliley, Representative Larry Combest, Representative John Dingell, Representative John LaFalce, Representative Jim Leach, and Representative Charles Stenholm in their capacities as Chairs or Ranking Minority Members of other concerned Senate and House Committees and Subcommittees. We are also sending copies of this report to the Honorable Alan Greenspan, Chairman, the Federal Reserve Board of Governors; the Honorable Arthur Levitt, Chairman, SEC; the Honorable William Rainer, Chairman, CFTC; and the Honorable Lawrence Summers, Secretary of the Treasury. Copies will also be made available to others upon request.

If you have any questions on matters discussed in this report, please contact me or Orice M. Williams at (202) 512-8678. The other major contributor to this report was Tonita W. Gillich.

Sincerely yours,

Thomas J. McCool
Director, Financial Institutions
and Markets Issues

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Abbreviations

CFTC	Commodity Futures Trading Commission
FDIC	Federal Deposit Insurance Corporation
FRBNY	Federal Reserve Bank of New York
LTCM	Long-Term Capital Management
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency
OTC	over-the-counter
OTS	Office of Thrift Supervision
SEC	Securities and Exchange Commission
Y2K	Year 2000

Overview of the Issues the Working Group Was Required to Consider

The executive order establishing the Working Group included 29 issues that the Working Group was required to consider. The issues were divided among (1) investor confidence, (2) the credit system, (3) market mechanisms, and (4) the regulatory structure. In May 1988, the Working Group issued its report, which included recommendations that generally addressed some aspect of each of the 29 issues. Most of the recommendations were to be carried out by the relevant agencies, primarily the Securities and Exchange Commission (SEC) and/or the Commodity Futures Trading Commission (CFTC) and the securities and futures exchanges they regulate. According to SEC and CFTC officials, although work on some of the issues was completed, work on others was an ongoing process. Table I.1 shows the issues the executive order required the Working Group to consider.

Although all of the issues have been considered, the action taken varies. SEC and CFTC officials said that action on some of the issues is considered part of an ongoing process or review. For example, all of the issues listed under "Credit system issues" were considered to be part of a continuing process that included ongoing reviews and revisions to regulations, standards, and approaches. Other issues were considered by SEC and/or CFTC and the securities and futures exchanges that they regulate, but they were not pursued because implementing them was determined not to be feasible or practicable. For example, according to SEC officials, some of these issues, such as price limits on individual stocks, were the result of academic articles and were considered and rejected by the agencies and exchanges. Some issues, such as "establishment of separate trading of index baskets of stock," were attempted and withdrawn due to lack of investor interest. Finally, other issues were considered, and the actions taken were considered complete. One example involved the issues related to circuit breakers, which officials generally considered completed following the 1998 revisions.

Table I.1. The Issues Articulated in the Executive Order

Issue for consideration
Investor confidence
1. Adequacy of mechanisms to address intermarket frontrunning and price manipulation.
2. Expansion of information dissemination and trade processing capacities of exchanges, member firms, service bureaus, and clearing systems.
3. Better evaluation and enforcement of affirmative market-maker obligations.
4. Adequacy of customer protection rules and their enforcement in all markets.
5. Adequacy of regulatory agency and self-regulatory organizatikon resources and staffing levels.
6. Assessment of a variety of approaches to ensuring better access and order execution for individuals' orders.

Issue for consideration
Credit system issues
7. Coordination of clearing system operations and information exchange.
8. Adequacy of private sector capital for futures floor traders, market-makers, broker-dealers, and futures commission merchants—including any appropriate revisions of capital rules.
9. Adequacy and clarity of private sector credit arrangements for exchange settlement systems and market participants.
10. Progress toward on-line clearing and same-day trade comparisons for all equity and derivative products.
11. Changes in margin requirements and additional security deposits for financial protection against price-spike volatility, settlement capability for variation margin, and positions with concentrated risk.
12. Establishment of harmonized leverage requirements for uncovered customer positions in cash and derivative markets.
Market mechanisms
13. The desirability of simultaneous, brief trading halts in all markets based on clear authority and carefully established and known standards.
14. Coordination of options and continuing trading of index futures and options with the trading of the underlying stocks.
15. Establishment of separate trading of index “baskets” of stock.
16. Providing for or requiring physical delivery for settlement of index futures and options.
17. Development of block trading procedures for index futures and options on futures.
18. Revision of the equity market short-sale rules.
19. Use of “open outcry,” “one price auction,” and specialist book disclosure approaches in large, intraday order imbalance situations in specialist markets to facilitate price discovery and market clearing and minimize intermarket disruptions and discontinuities.
20. Emergency measures to restrict large, rapid liquidations of positions.
21. Preestablished standards for shortened trading hour for all markets in periods of sustained heavy volume.
22. Investigation of the usefulness of enhanced reporting requirements for broker-dealer recordkeeping, large trader tracking systems, and program traders, with due consideration to financial privacy concerns and international capital flows.
23. Imposition of price limits for index futures and options.
24. Full-day clearings in response to specified price moves.
25. Restrictions on access to the Designated Order Turnaround system for program trades based on either volume or price move limits.
26. Price limits on individual stocks.
27. Aggregate cash and derivative market position limits.
Regulatory structure
28. Careful consideration of the desirability of more formal intermarket coordination and cooperation mechanisms, different regulatory regimes, a “tie-breaking referee” for intermarket issues, or emergency powers.
29. Development of mechanisms for international coordination on multimarket issues.

Source: Interim Report of the Working Group on Financial Markets; SEC, CFTC, Federal Reserve, and Treasury Interagency Coordination Reports; and interviews with SEC and CFTC officials.

Comments From the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

UNDER SECRETARY

December 29, 1999

Thomas J. McCool
Director, Financial Institutions and
Markets Issues
U.S. General Accounting Office
441 G Street, NW
Washington, D.C. 20548

Dear Mr. McCool:

Thank you for your letter to Secretary Summers and for the opportunity to review and comment on the draft report of the General Accounting Office ("GAO") entitled, Federal Financial Regulatory Coordination: The Role and Functioning of the President's Working Group on Financial Markets.

We believe that the President's Working Group has a well-established record of coordinating the development of policies aimed at enhancing the integrity, efficiency, orderliness and competitiveness of our financial markets. Most recently, the Working Group's major reports — Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management, April 1999, and Over-the-Counter Derivatives Markets and the Commodity Exchange Act, November 1999 — outlined a series of regulatory, legislative, and other recommendations. These recommendations, if implemented in full, could contribute substantially to the financial markets by enhancing disclosure and transparency, strengthening risk-management practices, providing legal certainty for the derivatives markets, and reducing systemic risk.

The President's Working Group provides a productive and valuable forum through which the member agencies coordinate responses, share information, and shape policy related to the financial markets, as exemplified by our recent reports. We believe that the group successfully plays an important role in providing a flexible forum for rapid response to the challenges of overseeing our nation's financial markets.

Sincerely,

Gary Gensler
Under Secretary for Domestic Finance

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