The Federal Reserve Board

Testimony of Chairman Alan Greenspan

The regulation of OTC derivatives
Before the Committee on Banking and Financial Services, U.S. House of Representatives
July 24, 1998

I am pleased to be here today to present the Federal Reserve Board's views on the regulation of over-the-counter (OTC) derivatives. Under Secretary Hawke has already addressed the specific questions raised in your letter of invitation. The Board generally agrees with the Treasury Department's views on these issues. In particular, the Board supports a standstill of attempts by the Commodity Futures Trading Commission (CFTC) to impose new regulations on OTC derivatives as a minimalist approach to our longstanding concerns about CFTC assertions of authority in this area.[1] In my testimony I shall step back from these issues of immediate concern and address the fundamental underlying issue, that is, whether it is appropriate to apply the Commodity Exchange Act (CEA) to over-the-counter derivatives (and, indeed, to financial derivatives generally) in order to achieve the CEA's objectives--deterring market manipulation and protecting investors.

The CEA and Its Objectives

The Commodity Exchange Act of 1936 and its predecessor the Grain Futures Act of 1922 were a response to the perceived problems of manipulation of grain markets that were particularly evident in the latter part of the nineteenth and early part of the twentieth centuries. For example, endeavors to corner markets in wheat, while rarely successful, often led to temporary, but sharp, increases in prices that engendered very large losses to those short sellers of futures contracts who had no alternative but to buy and deliver grain under their contractual obligations. Because quantities of grain following a harvest are generally known and limited, it is possible, at least in principle, to corner a market.

It is not possible to corner a market for financial futures where the underlying asset or its equivalent is in essentially unlimited supply. Financial derivative contracts are fundamentally different from agricultural futures owing to the nature of the underlying asset from which the derivative contract is "derived." Supplies of foreign exchange, government securities, and certain other financial instruments are being continuously replenished, and large inventories held throughout the world are immediately available to be offered in markets if traders endeavor to create an artificial shortage. Thus, unlike commodities whose supply is limited to a particular growing season and finite carryover, the