CPM Group

Precious Metals and Commodities
Research, Consulting, and Merchant Banking

9 October 2002

Dear Sir:

This letter is a response to the letter, dated 18 September 2002, from the Federal Reserve Board, the Department of the Treasury, the Securities and Exchange Commission, and the Commodity Futures Trading Commission to various senators, related to pending legislation regarding OTC derivatives. You asked for our comments on the contents of that earlier letter.

CPM Group is only somewhat familiar with the proposed legislation, so we cannot pass judgment on the wisdom of that proposal. Without reviewing the actual legislation, it is our understanding that the legislation contains various provisions which are totally inappropriate for the OTC derivatives market, and for financial markets in general, including wording which would prohibit offsetting contracts and closure of positions prior to maturity.

The letter dated 18 September 2002 does not refer to any of these inappropriate positions, however, but focuses almost exclusively on issues related to full disclosure of pricing, pricing transparency, and making information available to consumers of OTC derivatives that might allow them to make informed and more intelligent decisions as to whether individual OTC contracts are suitable for them to purchase.

We can comment on some of what we feel are several inaccurate statements in the Administration's letter regarding OTC derivatives. CPM Group is one of the leading authorities on derivative markets. We are independent of all banks and brokerage companies that underwrite these financial instruments, as well as regulated exchanges, which allows us a unique objectivity that is simply not possible with other authorities on these subjects.

The Administration's letter misrepresents the realities of the derivatives markets for commodities, equities, currencies, and debt instruments. It also misrepresents the potential consequences of regulations which would require greater transparency and accountability on the part of derivatives underwriters. We have great respect for Alan Greenspan, who was one of the four signatories of this letter, and find it difficult to believe he would sign such a statement. Other derivatives market experts that have seen the letter have expressed equal surprise at the contents.

The basic thesis of the Administration's argument is that the market would not benefit from greater transparency and more broadly available price information. This flies in the face of the basic economic theories and tenets on which free market economies are based. It also contradicts historically established empirical knowledge and experience in virtually every sector of the economy. At any time, it seems inexplicable that representatives of the four largest financial regulatory bodies of the United States would espouse such views. Given the current wave of disclosures of inappropriate, unethical, and possibly even

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illegal behavior by banks, brokers, and dealers, including simply lying to even their largest derivatives clients, it is all the more incredible that these four people would make such statements that could be interpreted as being against free markets with full price discovery for all market participants.

The letter is full of other misrepresentations of the derivatives markets. For one thing, the letter states that "Public disclosure of pricing data for customized OTC transactions would not improve the overall price discovery process and may lead to confusion as to the appropriate pricing for other transactions, as terms and conditions can vary by contract." This is not true. In fact, the current situation leads to inefficient pricing of derivatives. Academic economists have studied the seeming paradox that derivatives pricing structures clearly are more expensive than one would expect them to be, given efficient market theories and arbitrage and competitive opportunities. The reasons include the fact that these are not efficient markets, and that consumers of derivative products cannot get accurate price information.

The previous quote was from the third paragraph of the letter. The fourth paragraph of the letter states that "If dealers had to divulge promptly the proprietary details and pricing of these instruments, the incentive to allocate capital to developing and finding markets for these highly complex instruments would be lessened." First, let us be clear on one fact: The proprietary nature of the contexts and structure of these hedges is very low. Most of these instruments cannot be patented or copyrighted because the structure in reality is so generic and straightforward. Second, you should understand that all of the competitors of issuers of these notes fully know how these derivatives are structured and priced, and already readily replicate any and all of these instruments. It's a game among analysts here on Wall Street to deconstruct and reconstruct new derivatives offered by others. Keeping the pricing information and structure confidential does not protect the competitive advantage of the banks and brokers issuing these instruments in any way, since their competitors all know everything about them. The secrecy only makes these instruments, including their price and credit risk consequences, opaque to the banks' and brokerage companies' customers. There is no competitive advantage allowed by the secrecy. Rather it is an anti-consumer secrecy.

The Administration's letter has numerous other inaccurate statements. It states that trading of derivatives arbitrages away inefficiencies in pricing these instruments. It does not. It also says that the four signatories, or their agencies, cannot imagine who would benefit from proper pricing information being available to consumers of these instruments. The answer is hard to put succinctly, because there are so many groups in society that would benefit. Benefits would accrue to the consuming companies and institutional investors, and most importantly to their shareholders. Tax payers who suffer from the macroeconomic consequences of the financial losses due to frequent failures in the opaque derivatives market also would benefit. Those same tax payers also have to pay for the prosecutors in the numerous criminal cases related to inappropriate sales and use of such instruments, and payers of insurance premia to cover the enormous financial losses involved in the present opaque derivatives markets.

It is particularly stunning that the Administration would seem to be attempting to protect the ability to distort the financial pricing systems involved in these derivatives at this time, when major sellers of derivatives are being investigated or already stand accused of the most egregious and reprehensible lies and distortions in the pricing of energy derivatives, including the outright and simple falsification and lying about the market prices of derivatives to major customers.

In our work with numerous intergovernmental organizations related to bringing commodity derivatives to developing country agricultural groups, one of the points we have repeatedly stressed has been the degree to which banks and brokerage companies will mis-price, over-price, and sell totally inappropriate

derivatives to even the largest and most sophisticated corporations and institutional investors. This has been the history of derivatives marketing by banks and brokerage companies since options market liberalization emerged in the middle of the 1980s. In fact, earlier this year we sent a letter to a number of market regulators in several countries, outlining a simple set of regulations related to requiring banks to provide their customers information on the price and credit implications of derivatives products prior to their sale.

In summary, we cannot understand why the Administration would take this position, at this or any time. We would be interested in knowing why it did, and we would be willing to work with the Administration, Congress, and others, including your organization, to move toward a more intelligent approach to derivatives market oversight and regulation.

Sincerely,

"jeff christian"

Jeffrey M. Christian
Managing Director

Attachment

Department of the Treasury
Board of Governors of the Federal Reserve System
U.S. Securities and Exchange Commission
Commodity Futures Trading Commission

September 18, 2002

The Honorable Michael D. Crapo
United States Senate
111 Russell Senate Office Building
Washington, DC 20510

The Honorable Zell B. Miller
United States Senate
257 Dirksen Senate Office Building
Washington, DC 20510

Dear Senators Crapo and Miller:

In response to your letter of September 13, we write to express our serious concerns about the legislative proposal to expand regulation of the over-the-counter (OTC) derivatives markets that has recently been proposed by Senators Harkin and Lugar.

We believe that the OTC derivatives markets in question have been a major contributor to our economy's ability to respond to the stresses and challenges of the last two years. This proposal would limit this contribution, thereby increasing the vulnerability of our economy to potential future stresses.

The proposal would subject market participants to disclosure of proprietary trading information and new capital requirements. We do not believe a public policy case exists to justify this governmental intervention. The OTC markets trade a wide variety of instruments. Many of these are idiosyncratic in nature. These customized markets generally do not serve a significant price discovery function for non-participants, nor do they permit retail investors to participate. Public disclosure of pricing data for customized OTC transactions would not improve the overall price discovery process and may lead to confusion as to the appropriate pricing for other transactions, as terms and conditions can vary by contract. The rationale for imposing capital requirements is unclear to us, and the proposal's capital requirements also could duplicate or conflict with existing regulatory capital requirements.

The trading of these instruments arbitrages away inefficiencies that exist in all financial and commodities markets. If dealers had to divulge promptly the proprietary details and pricing of these instruments, the incentive to allocate capital to developing and finding markets for these highly complex instruments would be lessened. The result

would be that the inefficiencies in other markets that derivatives have arbitraged away would reappear.

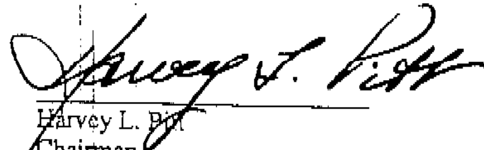
It is also unclear who would benefit from the proposed disclosures and regulations other than whoever simply copied existing products and instruments for their own short-term advantage. Weakening the protection of proprietary intellectual property rights in the market arena would undercut a complex of highly innovative markets that is among this nation's most valuable assets.

While the derivatives markets may seem far removed from the interests and concerns of consumers, the efficiency gains that these markets have fostered are enormously important to consumers and to our economy. We urge Congress to protect these markets' contributions to the economy, and to be aware of the potential unintended consequences of current legislative proposals.

Yours truly,

Paul H. O'Neill
Secretary
Department of the Treasury

Alan Greenspan
Chairman
Board of Governors of the
Federal Reserve System



Harvey L. Pitt
Chairman
U.S. Securities and Exchange
Commission

James E. Newsome
Chairman
Commodity Futures Trading
Commission

cc: Senator Daschle
Senator Feinstein
Senator Gramm
Senator Harkin
Senator Lugar
Senator Lott
Senator Sarbanes