TESTIMONY OF PAUL G. KIMBALL BEFORE THE HOUSE AGRICULTURE SUBCOMMITTEE ON RISK MANAGEMENT, RESEARCH, AND SPECIALTY CROPS

TESTIMONY OF PAUL G. KIMBALL BEFORE THE HOUSE AGRICULTURE SUBCOMMITTEE ON RISK MANAGEMENT, RESEARCH, AND SPECIALTY CROPS

MAY 20, 1999

Chairman Ewing and members of the Subcommittee, I am delighted to be here this morning to talk about the importance of the foreign exchange market in the context of your deliberations over the future of the Commodity Exchange Act and the Commodity Futures Trading Commission. I request that my entire written statement be included in the record, in case I have to abbreviate my remarks because of time constraints.

My name is Paul Kimball. I have been trading foreign exchange for almost twenty-five years, and I am currently a managing director of Morgan Stanley Dean Witter. The Foreign Exchange Committee, which I chair, was formed in 1978 under the sponsorship of the Federal Reserve Bank of New York and includes representatives of major international banks and brokers active in foreign exchange markets. We have decades of experience—not only in foreign exchange, but also in exchange-traded futures and other over-the-counter markets. In that vein I should note that I am on the board of directors of the Chicago Mercantile Exchange—and, moreover, that I am not the only member of the Foreign Exchange Committee to serve in such a capacity.

THE IMPORTANCE OF THE FOREIGN EXCHANGE MARKET FOR THE U.S. ECONOMY

Companies trade foreign exchange for a number of reasons. One simple example would be when industrial concerns, agricultural firms, and other corporations need to buy or sell foreign currency in order to buy or sell products abroad. For example, if a manufacturer of agricultural machinery or an exporter of wheat sells its goods in a foreign country, it will need to convert that foreign money into U.S. dollars in order to bring those profits back to the United States. The same company may need to pay employees or open an office abroad, which means that it may need to convert U.S. dollars into the currency of that foreign country where it is doing business.

A foreign exchange trade itself has three necessary stages that cannot be separated from one another. First, there is trade execution, which is the process by which companies bargain over prices for foreign exchange deals and actually strike a deal. Next, there are trade clearing and trade settlement, the processes by which companies arrange to pay what they owe each other as a result of their deals. Without one, you can't have the others.

Trading is global in scope. This is an astoundingly huge market: the equivalent of almost $1.5 *trillion* of foreign exchange is traded around the world *every day*. We have all admired the growth of the stock market over the past few years, but it is worth noting that in the United States alone, the size of foreign exchange turnover is seven times the size of the stock and bond markets combined.

I could continue to throw out large numbers, but the real story of foreign exchange is the way in which it helps U.S. companies, their employees, and consumers find a place in the worldwide marketplace. Being able to buy, sell, trade, and invest in foreign exchange helps businesses—not just in New York, Chicago, and Los Angeles, but also in Peoria, Omaha, and Modesto—import, export, expand, employ workers, and compete. A freely functioning over-the-counter marketplace in foreign exchange has been essential to the U.S. economy and should be allowed to play an even greater role in the future.

COMPETITION AND INNOVATION IN THE FOREIGN EXCHANGE MARKET

If you think that a huge global market like foreign exchange is extremely competitive, then you are absolutely right. Competition is fierce, not only among the many financial institutions that deal in foreign exchange, but also among the centers for over-the-counter foreign exchange dealing that have prospered around the world. The United States is by no means the only game in town. Only 25 percent of the world's foreign exchange activity occurs in this country: London has a bigger share of the market than we do, and their lead actually keeps increasing. There are a host of other cities—Tokyo, Singapore, Hong Kong, and Frankfurt among them—that would love to increase their share of business at our expense.

As a result of the competition among foreign exchange firms and dealing centers, there has been a great deal of technological innovation in the way the foreign exchange business is conducted. I am talking about the trade execution, clearing, and settlement stages of a foreign exchange trade, which I mentioned before. Foreign exchange business that used to be transacted over the phone and on paper is now done by computer: it has revolutionized our business as much as personal computers have changed the way Americans do office work. As a result, trade execution, clearing, and settlement have become more seamless, more efficient, and less risky.

The use of automation in the foreign exchange market has also been the result of regulatory pressures by banking and securities regulators around the world, who are quite knowledgeable about the functioning of our business. For example, the Basel Supervisors Committee, which is composed of supervisors from leading industrialized countries—including the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation from the United States—has called upon our industry to make specific technological advances that reduce risks. Some of these techniques enable firms to reduce certain risks as much as 90 percent. In order to ensure the vigor and safety of the U.S. foreign exchange market in the future, the current regulatory environment that has fostered these initiatives must not be changed.

Competition and electronic execution, clearing, and settlement in foreign exchange have meant two things. First, they have made firms like mine deliver our services faster, better, cheaper, and safer for the businesses that use foreign exchange. That is obviously good news for U.S. companies that are dependent on this market. Second, competition makes foreign exchange dealers very wary of doing business in countries where any aspect of foreign exchange trading—especially the use of automation—has unnecessary regulatory burdens.

The over-the-counter foreign exchange market in the United States needs no additional regulation. Accordingly, this business will move overseas and become greatly diminished in the United States if greater regulatory burdens result from this Subcommittee's deliberations. I'll admit that this has strategic and financial implications for my firm and me. But more important, it means that foreign exchange trading would become more difficult and expensive for U.S. firms that need it to grow and compete. That would be bad for U.S. companies, bad for their employees and their communities, and bad for the U.S. economy.

SUPERVISION AND SELF-POLICING IN THE FOREIGN EXCHANGE MARKETS

The foreign exchange market is already subject to a great deal of effective external and internal regulation, which is another reason for the Subcommittee to avoid imposing new regulatory burdens on this business.

First, the vast preponderance of institutions that serve as dealers in the foreign exchange market are very sophisticated financial institutions regulated by any number of state and federal regulators in the United States. The Securities and Exchange Commission, the Federal Reserve, the Comptroller of the Currency—these are among the financial industry regulators that scrutinize trading activities like foreign exchange, depending on the legal entities firms like mine choose to use for this type of activity. Add to that mix the potent laws against fraud that exist at the federal and state levels, which guard against dishonesty and unfair dealing in the professional market.

Finally, consider the many successful efforts at self-policing that institutions active in foreign exchange have initiated over the past twenty years. Those of us who make our livelihood in foreign exchange take our industry's reputation very seriously; we know that even one bad apple can spoil our record. The Foreign Exchange Committee and other similar groups have, for years, published best practice guides, alerts, and letters that have helped raise standards to a very high level.

The foreign exchange business in the United States has done a better job than even some very heavily government-regulated markets in maintaining the level of integrity with which we do our jobs. No wonder there has been an absence of serious scandals, lawsuits, and disruptions in the professional foreign exchange market. I believe that the effective supervisory oversight of most institutions in the foreign exchange market, combined with the standards that the industry has itself embraced, should be a model—rather than a target—for the Subcommittee to consider as it turns to the future of the Commodity Exchange Act.

VIEWS OF THE FOREIGN EXCHANGE COMMITTEE

Mr. Chairman, we have Congress to thank for the competitive, efficient, and effective over-the-counter foreign exchange market in the United States today. The reason is the enactment of the so-called Treasury Amendment in 1974, which sought to ensure that the Commodity Exchange Act would never interfere with or otherwise affect foreign exchange trading, except when it occurred on futures exchanges like the ones this Subcommittee oversees. The Treasury Amendment represented an insightful decision by Congress to allow the foreign exchange market to flourish and grow—and along with it, the U.S. businesses and consumers that benefit from this market. It was designed precisely to foster advances like those in electronic trading that I've mentioned today.

Our very important foreign exchange market depends on the Treasury Amendment, and because of that, we urge Congress to preserve the intent of the Treasury Amendment going forward. Congress should clarify the Treasury Amendment so that it fully excludes over-the-counter foreign exchange trading from the Commodity Exchange Act—including any elements of trade execution, clearing, and settlement that have or will become automated. In doing so, you can ensure that the innovation, efficiency, safeguards, and economic growth brought to this country by the professional foreign exchange market will continue.

You will notice that I just referred to what I called the "professional" foreign exchange market. By that, I mean foreign exchange trading that is done between entities that are big enough not to need special regulatory protection. The Foreign Exchange Committee feels strongly that the law *should* provide appropriate protections for victims of unregulated "bucket shops" that take advantage of small customers at the retail level.

I understand that Congress may feel pressure to impose new regulatory burdens on the over-the-counter foreign exchange market as a result of the regulatory burdens currently faced by futures exchanges. As an employee of a firm having operations regulated by the Commodity Futures Trading Commission, I know the burdens of the Commodity Exchange Act. But I hope you would agree that regulation for regulation's sake is never a good idea. Moreover, as I learned long before I became a foreign exchange trader or a member of the board of the Chicago Merc, two wrongs don't make a right.

Mr. Chairman and members of the Subcommittee, I deeply appreciate the opportunity to tell you more about what we have accomplished in the over-the-counter foreign exchange market and its importance to our economy. The Foreign Exchange Committee is honored to be included in a discussion of issues that have such tremendous significance for our economic future.