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PRESIDENT'S WORKING GROUP REPORT OF OTC DERIVATIVES—CEA RE-AUTHORIZATION

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

ON

PRESIDENT'S WORKING GROUP REPORT OF OTC DERIVATIVES—CEA RE-AUTHORIZATION

FEBRUARY 10, 2000

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PRESIDENT'S WORKING GROUP REPORT OF OTC DERIVATIVES—CEA RE-AUTHORIZATION

THURSDAY, FEBRUARY 10, 2000

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The Committee met, pursuant to notice, at 9:05 a.m., in room SH–216, Hart Senate Office Building, Hon. Richard G. Lugar, (Chairman of the Committee), presiding.

Present or submitting a statement: Senators Lugar, Fitzgerald, Grassley, Harkin, and Conrad.

OPENING STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA, CHAIRMAN, COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

The CHAIRMAN. This meeting of the Senate Agriculture Committee is called to order. Today the Committee holds its first hearing of this year on the reauthorization of the Commodity Exchange Act. This hearing with its distinguished list of witnesses will discuss the unanimous findings of the President's Working Group regarding the proper treatment of over-the-counter derivatives markets.

In late 1998, House Agriculture Committee Chairman Bob Smith and I wrote Treasury Secretary Rubin requesting that the President's Working Group study and make recommendations to Congress regarding these instruments. Our request came on the heels of an economically turbulent period which witnessed a Russian default of debt, the devaluing of the ruble and the near collapse of Long Term Capital Management Hedge Fund.

In addition, the CFTC was making overtures through its concept release on the over-the-counter derivatives that it might seek to unilaterally regulate these instruments. In requesting this report, we sought to bring certainty to these markets and to build a broad consensus on the Government's role, if any, in regulating them. I have stated that one of my goals for the Commodity Exchange Act reauthorization is to provide legal and regulatory certainty to the over-the-counter market. With its recommendations on the legal certainty of swaps, the Treasury Amendment, and electronic trading, I am confident this unanimous report will provide Congress with the guidance it needs for achieving this important goal.

But the Working Group's recommendations cannot exist in a vacuum. Another important goal of reauthorization is providing regulatory relief for those entities that fall within the Commodity Exchange Act. The Working Group recognized that its recommendations regarding the over-the-counter market must be implemented simultaneously with the lessening of regulation for the futures exchanges.

Along with other members from the House and Senate Agriculture Committees, I have requested the CFTC make its recommendations on regulatory relief by February 14. I understand that Chairman Rainer will meet this deadline and intends to brief members on the proposal shortly.

Addressing the Shad-Johnson Accord is also a priority. The President's Working Group agreed that the current prohibition on single stock futures can be repealed if issues regarding the integrity of the underlying securities market and regulatory disparities can be resolved. Senate Banking Committee Chairman Phil Gramm and I have written Securities and Exchange Commission [SEC] Chairman Levitt and CFTC Chairman Rainer requesting that the agencies study this issue and make recommendations by February 21.

Senator Gramm and I have pledged to work together throughout this process including the possibility of holding joint hearings to ensure that both over-the-counter and on-exchange instruments are appropriately and consistently treated under our laws. Although it would be premature today to discuss in detail the reform of Shad-Johnson Accord without the benefit of the agencies' input, I would emphasize that this issue remains a priority with the Committee.

Now this committee is finally faced with the daunting task of drafting this complicated legislation in a year drastically shortened by a full congressional calendar and a presidential election. In my view, given at least the advice of our Senate leadership on scheduling, we may have only a 3-month period to pass this bill or to resign ourselves to the fact that it will not get done until next year. However, the ramifications of waiting until next year are considerable given the fact that we will have a new administration, a new Congress, even possibly a new chairman of this committee. The present time appears to be most opportune and we are hopeful that we will have consensus in the industry for comprehensive reauthorization legislation promptly and I intend to actively promote passage this year.

Turning toward today's discussion, our first witness will be the Treasury Secretary Lawrence Summers, head of the President's Working Group, who will outline, first of all, the unanimous findings of the commission.

Our second distinguished panel will consist of other members of the Working Group including Chairman Alan Greenspan of the Federal Reserve; Chairman Bill Rainer of the CFTC; and Ms. Annette Nazareth, Director of Market Regulations of the SEC.

Our final panel will contain members from the private sector including representatives from the futures exchanges and the over-the-counter derivatives community. I would say in advance that we have been advised that a roll call vote will occur at 11 o'clock. We will have a short recess so that members may do their duty and then we will return so that we can have a full hearing of all the witnesses and questions by the Senators.

[The prepared statement of Senator Lugar, can be found in the appendix on page 50.]

Before I ask for our distinguished first witness to commence his testimony, I would turn to Senator Conrad for any opening comment he might have.

STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. Thank you, Mr. Chairman. Special thanks for your leadership in this area. Obviously this is critically important, important to our country, important to world financial markets as well. This is something we simply have to get right. The world is changing everyday around us. Last night I was hooked up to my Web TV surfing the net and going to various financial sites. It is just remarkable the information and the access to markets that are now available to everybody everywhere in the world that has access to the internet.

This changes everything and we have got to be very mindful of two things. One, we have got to protect those who are participants in the market and, second, we have got to make certain that our industry can be fully competitive. We do not want to do things unintentionally that will prevent our companies from being able to compete on a global basis. I think those of us who have passed around the book, The Lexus and the Olive Tree, understand how globalization is altering the speed with which everybody has to respond, those who are in the private sector and those of us who are in government. Government moves much more slowly than does the private sector and we are going to have to speed up because things are changing everyday in every way and if we do not respond quickly, we are going to leave our people at a competitive disadvantage.

So again, Mr. Chairman, we are going to have to strike a balance. We are going to have to find how we balance the competing interests of making certain that our companies are competitive and at the same time protecting participants in the market. I again want to thank you, Mr. Chairman. I look forward to the panels that you have called before us.

The CHAIRMAN. I thank the Senator for his faithful work on this issue as well as all other issues and his prompt attendance at these nine o'clock hearings. I now call upon Senator——

Senator CONRAD. You know in North Dakota, we usually are up by five so it is a little late to get started.

The CHAIRMAN. I understand. Senator Fitzgerald.

STATEMENT OF HON. PETER G. FITZGERALD, A U.S. SENATOR FROM ILLINOIS

Senator FITZGERALD. Well, thank you, Mr. Chairman, and if I could have leave of the Committee to introduce my remarks to the record, I would appreciate that.

The CHAIRMAN. They will be published in full.

Senator FITZGERALD. Well, thank you, and I would just like to make a couple of comments. Obviously, as the Senator from Illinois who represents Chicago and LaSalle Street and the futures business there, I have a great interest in these particular hearings. I thought the Working Group's report was very thorough and had many good elements and I was impressed that it left open the possibility of a level regulatory playing field for technically futures products and financial derivatives that are not technically futures. It left open the possibility of a level regulatory playing field where only institutional counter parties were involved. That is an interesting issue and we will want to pursue that more.

What I would be concerned of at the outset is fragmenting the market between the retail and institutional customers. I think we have to ask whether there is a public policy interest sufficient to justify taking retail customers out of having access to that large institutional market and that is something that we need to focus on.

But as I read the Working Group's reports and some of the testimony that has been submitted beforehand, there seemed to be an openness on the part of most of the members of the Working Group to have that level regulatory playing field between traditional futures products and over-the-counter off-exchange financial derivatives but only in the case of institutional parties. I think we are going to have to pursue that a little bit more, but with that, I would like to welcome Secretary Summers to the Committee and thank the Chairman, Senator Lugar, for holding these important hearings.

The CHAIRMAN. I thank the Senator for his special interest in this subject and we look forward to working with you. Let me ask that the first witness, Secretary Summers, attempt to summarize remarks in a 10-minute period. We will not be overly rigorous because the report is very important. Your testimony will be published in full and it is an important statement. Likewise with our second panel of those who have been working with you as members, we will ask each to have a 10-minute opportunity and that would allow for questions as members come and go from the hearing, but we want to make certain that we have plenty of dialogue with all of us. It is a pleasure to have you, Secretary Summers. I see that you are accompanied by a distinguished fellow alumni of mine at Denison University, Lee Sachs, also a trustee of that institution, which gives him special standing as you are sitting there.

[Laughter.]

We are grateful for your participation as always. Your leadership in this has been extremely important and you have been most forthcoming with members of the Committee. Senator Harkin has arrived and I will ask, do you want to make a comment now or maybe later?

Senator HARKIN. Have others made remarks?

The CHAIRMAN. Yes. Senator Conrad made a comment.

Senator HARKIN. Just briefly.

The CHAIRMAN. Very well. Go ahead.

STATEMENT OF HON. TOM HARKIN, A U.S. SENATOR FROM IOWA, RANKING MEMBER, COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

Senator HARKIN. Thank you, Mr. Chairman. I am sorry. I just had a previous engagement. I am sorry for being a little late, but I want to thank you, Mr. Chairman, for holding this important hearing on the report of the President's Working Group on the over-the-counter derivatives markets. I, first of all, take my hat off to you for chairing on three consecutive days two hearings on dairy policy and one on financial derivatives, two of the most esoteric and mystifying subjects to ever come before this committee.

So I very much look forward to receiving the testimony from Secretary Summers and others who are here and working with you, Mr. Chairman, to craft legislation that we can enact this year. We have made a good effort at it. Three years ago we worked together in a bipartisan fashion toward a consensus bill, but for some reason the stars were not quite aligned at that time. I am optimistic now that the circumstances are more auspicious that we can move ahead on new legislation. The report of the President's Working Group should be very helpful to us in that regard.

Again, with the rapid changes that we see in the technology and in the financial markets, it is essential that the CEA is updated to reflect these changes that have occurred and again to just make sure that we accommodate some of the future changes that are coming.

Any regulatory system becomes counterproductive if it inhibits innovation and the creation of new and beneficial products and services. So again I just want to underscore the importance of avoiding action that would help the financial markets but in any way damage the functioning of the agricultural markets.

Finally I want to stress that when we pass legislation, we take responsibility for its consequences. So as we work on regulatory reform legislation, we have to be sure we do all we can to guard against unforeseen risks, especially systemic risks to the broader financial system that could come back to haunt us later on. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Harkin.

Secretary Summers.

STATEMENT OF HON. LAWRENCE SUMMERS, SECRETARY, U.S. DEPARTMENT OF TREASURY, ACCOMPANIED BY LEWIS A. SACHS, ASSISTANT SECRETARY FOR FINANCIAL MARKETS, U.S. DEPARTMENT OF TREASURY

Secretary SUMMERS. Mr. Chairman, Senator Harkin, Senator Fitzgerald, Senator Conrad, thank you very much for giving us the opportunity to discuss the report of the President's Working Group on Financial Markets on Over-the-Counter Derivatives and the Commodity Exchange Act. Let me say that we very much share your view on both the importance and the urgency of these issues for the Nation's financial markets and for the economy.

This report reflects a great deal of effort on the part of the members of the President's Working Group including the Chairmen of the Federal Reserve, CFTC and SEC. After a great deal of effort, we were able to reach unanimous recommendations and it is my very great hope that they can be enacted into law this year.

Let me address three subjects in my remarks this morning. First, the importance of OTC derivatives to the economy, then the objectives that guided members of the Working Group in formulating their recommendations, and third, the six recommendations of the Working Group.

OTC derivatives now represent more than $80 trillion in notional value. They perform a crucial function in helping to share and allocate risk around our nation's economy. This confers a number of benefits. It helps businesses and financial institutions to hedge risks and lower their costs, thereby reducing prices for American businesses and consumers. It promotes more efficient allocation of capital across different sectors of the economy. It encourages better information with respect to the risks of various contingencies and promotes transparency which leads to better planning, and it permits the development of more imortive financial products by allowing for wider sharing of risk.

The market is a valuable one and it can deliver many benefits to those who make proper use of it. For example, the agricultural sector benefits considerably from OTC derivatives used by importers and exporters of agricultural commodities. By using these products, they hedge their exposure to volatile movements in foreign currency markets and can build on the certainty to invest more in their businesses, allowing farmers to export more of their products to overseas markets.

Mr. Chairman, I think we all have an obligation to work as rapidly as possible to develop a legal framework that is as modern as the market that it addresses. It is our judgment that because the counter parties to OTC transactions are highly sophisticated and because the issues involved are enormously complex, government can best contribute by promoting a framework for market discipline based on the principle of transparency. The objective of government should not be to protect individual institutions but to protect the system. And, of course, government should have a continuing role with respect to the protection of retail customers.

With these broad principles in mind, our report had four objectives in developing a legal framework for this market: First, the reduction of systemic risk; second, the promotion of innovation; third, the protection of retail customers; and fourth, ensuring U.S. competitiveness in an important industry where there is a great deal of innovation taking place.

With these four considerations, systemic risk, innovation, retail protection, and U.S. competitiveness, we developed six recommendations. Let me highlight, Mr. Chairman, that a failure to enact legislation along these lines would, in our judgment, carry important risks with respect to each of our objectives: the mitigation of systemic risk, the promotion of innovation, the protection of retail customers, and the competitive of the U.S. financial industry.

Our six recommendations. First, to create an exclusion from the CEA for most swaps agreements. Because the combination of the broad definition of commodity and the absence of any definition of futures contracts implies that the CEA may apply to transactions that no one anticipated in 1974, we believe that the exclusion for certain swaps between sophisticated counterparts is appropriate, consistent with market discipline, and should be put into law. I would add that the enactment of an exclusion promotes legal certainty that is essential for the integrity of the market.

Second, to create an exclusion for electronic trading systems. And third, to permit the use of appropriately regulated clearing systems for OTC derivatives. These two recommendations both go to the objective of allowing sophisticated parties to organize together to trade OTC derivatives in ways that are most efficient for them, in ways that promote transparency to each other and in ways that permit clearing arrangements which mitigate systemic risks in the event of counter party default.

Fourth, to clarify the original intent of the Treasury Amendment. As you will recall, Mr. Chairman, the Treasury Amendment goes to the question of regulation of trading in foreign exchange and government securities. The proposal here would clarify their exclusion from regulation on an organized exchange, but it would at the same time recognize the CFTC's authority with respect to bucket shops and other practices affecting retail customers.

The fifth and sixth recommendations are highly technical with respect to the exempt status of hybrid securities. These recommendations address some jurisdictional disputes, but I am pleased to report that the jurisdictional disputes have been resolved with the unanimous agreement of the parties involved.

Mr. Chairman, these are highly technical issues. But for being highly technical, they are nonetheless very important issues for the U.S. financial services industry and the contribution that the financial sector can make to the maintenance of a sound economy. We look forward to answering your questions and speaking on behalf of all the members of the Working Group hope it will be possible to enact these recommendations this year. Thank you and thank you for your leadership.

The CHAIRMAN. Thank you very much, Mr. Secretary. First, a technical question. Has the Department of the Treasury been working on any legislative language that reflects the findings of this Working Group?

Secretary SUMMERS. We do not have a full set of legislative language to share, but we have been thinking through ways in which various of these ideas can be expressed in legislative language and we would be very pleased to have our staffs be in touch regarding these issues.

The CHAIRMAN. I appreciate that because that will be a great help in making certain that the Working Group's findings and the conclusions you have reported today are appropriately reflected when we finally get to the language. Mr. Secretary, a broader question, and this was certainly a question before initial hearings on this subject. Now, clearly not only the financial markets but the public as a whole was intrigued and correspondingly alarmed by the failure of the Long Term Capital Management Hedge Fund and likewise the steps that were taken to try to bring that situation into some balance. At one of our hearings there was considerable argument over whether that failure meant that there were a lack of proper credit standards, a lack of appropriate regulation by someone.

Now, in essence, in the sophisticated ways in which the financial community deals in an international way, as you pointed out, are things simply at some point beyond our scope and if so what kind of jeopardy does this bring to the American economy, quite apart from financial markets, and to what extent has your group, the Working Group, thought about all of that and how are your recommendations appropriate, given those risks?

Secretary SUMMERS. I think you have raised a very important set of issues, Chairman Lugar, and they are a set of issues we gave a great deal of thought to in formulating our recommendations.

The Working Group, as you know, had prepared a separate report on issues raised by highly leveraged institutions. I would leave to others an attempt to fully analyze the LTCM episode, but I think most would feel that it represented a combination of leverage and illiquidity that led to those very serious difficulties. The approach that we have advocated in both the highly leveraged institutions report and this one is one based on the principle of promoting market and counter party discipline through greatly increased transparency and that is the focus of our recommendations.

We believe that the best discipline, the most informed discipline, on institutions can come from counter parties in the context of transparent sharing of information. Some of the recommendations that are contained in this report, though, to some degree do go crucially to the objective of systemic risk, including in particular the proposals to allow clearinghouses to be set up with respect to over-the-counter derivatives that will promote netting and therefore make large outstandings smaller and contribute to systemic stability.

I believe that we do, and I think this was the tone of several of the opening statements, do need to find a balance between assuring a framework that protects against systemic risk, on the one hand, and promoting innovation on the other, but I would hasten to say that we need to be very careful of establishing public regulation in a way that crowds out what is potentially more effective private regulation by counter parties.

The CHAIRMAN. Well, the private regulation idea is clearly an important one and if there is a bias in the report or at least a trend, it really moves toward more of that as opposed to public regulation. This is an age-old dispute in our own governmental system with the pendulum going backward and forward; clearly I favor that move toward more private regulation. This appears to be the way the CFTC and perhaps the SEC are moving, but at the same time, let me just ask this question.

Much of the Working Group's findings discuss what should remain outside of the Commodity Exchange Act. What policies should we focus on in determining instruments that should remain within the Commodity Exchange Act? In other words, what is sort of the core of that situation, as you see it, with regard both to innovation and growth and international competitiveness, but at the same time the basic public function of regulation which that commission and our oversight try to provide?

Secretary SUMMERS. I think the core rationales for public regulation in this area go to three things. They go to the protection of retail customers. Where retail customers are going to be substantially involved, there is certainly a case for strong regulation. Where price manipulation is a significant risk, particularly because of finiteness of supply, there is a very strong case for regulation. There will be cases where regulation can be constructive in terms of the promotion of transparency and the price discovery function. The balance that has to be struck involves a balance of recognizing when the need for regulation with respect to those considerations exceeds the costs, potential costs, in terms of reduction of innovation and loss of international competitiveness.

In general, where it is highly sophisticated and experienced parties trading with one another, we believe that the promotion of market discipline based on counter party scrutiny is likely to be most effective.

The CHAIRMAN. I thank you. I will ask each of our colleagues to stay within a 5-minute time limit on a first round. If there are additional questions, we will have a second round. I call on the ranking member, Senator Harkin.

Senator HARKIN. Thank you, Mr. Chairman. Mr. Secretary, you know, you said it very aptly when you said that we should be looking at the system itself and that government should not be picking winners and losers within the system but look at the system itself. I have been wrestling with this for a long time on the derivatives market. You see—and this is a question I am going to ask everyone that comes up here—right now we have an exemption. CFTC gives exemptions. What the Working Group has proposed is an exclusion.

What I wonder is if you have a problem that crops up, that signals that some kind of regulation or action needs to be taken? Something where you have tremendous leveraging, for example, going on like we had in the hedge funds, if you have an exclusion, then it would take an act of Congress to do something about it. That takes a long time. If you have an exemption, then the CFTC could respond more readily to something like that, that cropped up. That is an issue that I wrestle with a lot.

Now I understand the need for an exclusion, the certainty of contracts. I understand that. But I am wondering if within the framework of an exemption, you could not accomplish the same thing? I just throw that out as a question for you to ponder and if you have any response. In other words, with the exemption, they could impose a regulation right away to stop something that may be going out of control. With an exclusion, you have to have an act of Congress.

Secretary SUMMERS. Senator Harkin, I think in the latter part of your remarks, you forecast correctly what would be my response, which is you are clearly correct that an exemption provides more flexibility than an exclusion, but it is precisely the presence of that flexibility and the recognition that it might be used that undermines legal certainty and creates a greater possibility that these transactions will take place and be booked abroad where they will not be subject to American law. It is precisely that flexibility and the expectation that it might be used that is potentially reducing of confidence with respect to these transactions.

I do not think we would responsibly, nonetheless, favor exclusion in areas where strong public regulation would confer large benefits even despite that legal certainty consideration, but it is our judgment and the judgment of the staffs whose work went into this that in a range of financial transactions between very large and sophisticated institutions, the impact of public regulation in reducing the pressure for market discipline might actually be counterproductive and therefore the clear signal that an exclusion provides both would contribute to legal certainty and would contribute to greater pressure for the strongest possible market regulation.

Senator HARKIN. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Harkin. Senator Fitzgerald.

Senator FITZGERALD. Thank you, Mr. Chairman. I want to follow up on a question by Senator Lugar. He asked about where you thought regulation was necessary. If I remember correctly, you said essentially that you felt public regulation was necessary where retail customers were involved and where you are trading a product such as a commodity which theoretically at least could be susceptible to market manipulation. Somebody in theory could corner the market on grain. I took that to mean that cornering the market on financial derivative products is not as much of a possibility as where you have a finite commodity.

If that is your test for the necessity of public regulation, and we had a situation in which institutional parties are trading a future on a financial product as opposed to an agricultural commodity or some other commodity on an exchange, would you support having no public regulation and just allowing those counter parties in that case to police the market?

Secretary SUMMERS. Senator, I prefer not to comment in any real detail on issues that fall within the CFTC and Chairman Rainer's bailiwick. But I would say this. I think it is very important that while this report has focused, in line with the Chairman's request, on the OTC derivatives market, there are obviously a set of issues that arise with respect to exchange-traded products and that the same basic principles of motivating innovation, protecting retail, avoiding systemic risk, and being internationally competitive that we have stressed with respect to OTC derivatives also arise with respect to exchange-traded instruments and the same kind of balances need to be struck.

As the Chairman indicated in his opening statement, this is something that Chairman Rainer and the CFTC have been very much involved in and will be reporting on soon, and I would certainly support their efforts to remove any regulation which proves to be unneeded.

I would say that I think the merits with respect to the OTC derivatives market are very strong. The economic importance is very great. I would hope that, that important issue would not be held hostage to debates, whatever the merits on both sides are, with respect to the proper regulation of the exchanges.

Senator FITZGERALD. Now with respect to the swaps exclusion where institutional customers only are involved and retail customers are not involved, would that exclusion operate to deny retail customers access to the most liquid markets? Would it not encourage the creation of markets with pools of liquidity that are only available to the institutional participants?

Secretary SUMMERS. That clearly is a source of concern that has to be balanced, Senator Fitzgerald, but while I have said a number of things here that have suggested that in certain circumstances, regulation may not be constructive, I think it is important to remember that the premise of a view like the one you described is that regulation is all an excessive punitive burden, and in many cases, regulation can be a source of strength and integrity to markets. Indeed if you look at American financial markets, one of their strengths and one of the reasons why companies, for example, come to list here is the strength of our regulation. There has been some important recent economic research comparing securities markets in a number of the transition economies that have demonstrated that in certain cases, proper regulation with respect to issues like insider trading and the behavior by insiders can promote integrity, encourage people to trade there and promote liquidity.

So I think the conclusion that I would draw is that we need everywhere to avoid unnecessary and unconstructive regulation but that proper constructive regulation can strengthen a market's integrity, confidence and thereby promote its liquidity, and my hope, and I have great confidence that with Chairman Rainer's leadership the CFTC will get there, would be to take an approach of that kind with respect to the exchange-traded markets.

Senator FITZGERALD. Well, thank you and I do agree with your comment with respect to proper regulation. I think we have the best capital formation markets here in the United States because we have outstanding securities laws, and my hope would be that we could come up with a similarly outstanding model to cover our derivatives market. Thank you.

The CHAIRMAN. Thank you very much, Senator. Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman. I would like to follow up on the question by Senator Fitzgerald because I think it really goes to the heart of the controversy here and the questions that have to be answered by this committee. We had in Long Term Capital a situation in which there was enormous risk. There was huge leverage there and we saw a very fast action by government to bring together private parties to stem the tide there, to stop the hemorrhage. That could have become a very, very serious situation for the financial market and the confidence in financial markets.

Let me ask you this. You are talking about counter party scrutiny as being what we should we look to for these large sophisticated financial traders. What would you say to the public who is listening here to give them comfort in light of Long Term Capital? What happened to counter party scrutiny in that case? Why did it fail? What is before us now that is going to prevent a future failure?

Secretary SUMMERS. No one can sensibly sit here and assure you that there will not be more financial crises, that there will not be problems in the future, Senator Conrad. The Working Group's proposals, not with respect to OTC derivatives but with respect to highly leveraged institutions, included a variety of steps that were intended to reduce the risk of systemic risk coming from a situation like Long Term Capital. Those involved much greater requirement of transparency in their reporting to their creditors.

Senator CONRAD. When you use—I am sorry to interrupt, but when you say transparency, what do you mean by that? What is provided for here that makes these transactions more transparent for those who are involved? Is there more reporting of what a company's positions are so that others could see how highly leveraged they were?

Secretary SUMMERS. Yes. Yes, and, in particular, there is more reporting at two levels, both with respect to the expectation of the information that will be shared between leveraged institutions and banks or other institutions that provide them with credit, and as those institutions that are regulated by the Government are supervised, there is much closer scrutiny of their exposure to highly leveraged institutions such as hedge funds. Is this going to be totally satisfactory? I am sure there will be problems at some points in the future, but I think the concern, and I think it is a legitimate one, is that we need to act in a way that ensures that the maximum degree of responsibility is felt by counter parties who inherently will be much closer to these situations and better able to judge them than any set of regulators are ever likely to be.

There is a second type of policy response that is appropriate and one area where we get into it here is the Working Group's second recommendation with respect to clearinghouses which provides for arrangements in which there is some sharing of obligation and so credit can be extended with confidence that it will be repaid. And, greater reliance on clearinghouses, greater reliance on netting arrangements, more rapid settlements procedures, these are all very intricate issues, but if you look back to the time after LTCM, I think most would feel that better netting, faster settlements, more transparency, improved contractual relations in a variety of ways that reduce the pressure for forced liquidations are all constructive steps. With the support of those of us in the official sector, there have been a number of groups in the private sector that have come together to devise procedures and move forward along those directions.

But I would hasten to distinguish somewhat the issues that we have just been discussing, which are very important, from the issues that are the primary focus of this hearing. It is possible to leverage a position heavily and lose most or all of an institution's capital whether you are trading on an over-the-counter market or an exchange market. A substantial amount of the LTCM positions were actually on exchange-traded markets and the overwhelming preponderance of the Barings positions which had some similarity were traded on exchange markets. So, I think the set of issues involved in LTCM risk type problems is a somewhat different set of issues than the set of issues that are involved with respect to what type of markets we should have.

The CHAIRMAN. Thank you very much, Senator Conrad. Senator Grassley.

Senator GRASSLEY. Mr. Chairman, I do not have any questions but I would like permission to put an opening statement in the record.

The CHAIRMAN. It will be published in full.

[The prepared statement of Senator Grassley can be found in the appendix on page 52.]

Senator GRASSLEY. And I hope before I have to leave for the Finance Committee I get a chance to hear the next panel.

The CHAIRMAN. Very well. Are there other questions of senators of our distinguished witness? If not, we thank you very much, Secretary Summers, for your testimony and for your chairmanship.

[The prepared statement of Secretary Summers can be found in the appendix on page 54.]

The CHAIRMAN. The chair would like to call now a panel consisting of Chairman Alan Greenspan, Board of Governors of the Federal Reserve System; Chairman William Rainer of the Commodity

Futures Trading Commission; and Ms. Annette Nazareth, Director of Market Regulations, Securities and Exchange Commission.

I welcome the panel and I will ask that you testify in the order that I introduced you and that will be first of all Chairman Greenspan, then Chairman Rainer, and Ms. Nazareth. Each of you hopefully can give us 10-minutes or so of testimony and then as you noticed with the previous witness, we will have a round of questions by senators. Chairman Greenspan, it is always a privilege to have you before the Committee and we welcome you again today.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I shall endeavor to be somewhat more brief than 10-minutes, but I tend sometimes to ramble on so I may end up in that particular area. I am particularly pleased to be here today before you and your committee members to underscore the importance of this committee's efforts to modernize the Commodity Exchange Act and to express my support for the Working Group's recommendations.

Over-the-counter derivatives have come to play an exceptionally important role in our financial system and in our economy. These instruments allow users to unbundle risks and allocate them to the investors most willing and able to assume them. A growing number of financial and non-financial institutions have embraced derivatives as an integral part of their capital allocation and profit maximization.

In considering regulation of derivatives under the CEA, we need to keep in mind that imposing government regulation on a market can impair its efficiency. Thus, when evaluating the need for government regulation, it is essential that the public policy objectives be identified clearly. As the Working Group's report discusses, the primary public policy purposes of the CEA are to deter market manipulation and to protect investors against fraud and other unfair practices. We must, of course, assess whether government regulation is necessary to achieve those objectives.

As Secretary Summers has already testified, in the case of financial OTC derivatives transactions between professional counter parties, the Working Group has agreed that such regulation is unnecessary and that such transactions should be excluded from coverage of the act. Furthermore, the exclusion should extend to the electronic trading of such contracts by such participants.

The rationale for these positions is straightforward. OTC transactions in financial derivatives are not susceptible to manipulation, and professional counter parties simply do not require the protections that the CEA provides for retail investors.

The Working Group has also concluded that government oversight of clearing systems for over-the-counter derivatives is appropriate. However, provided such government oversight is in place, OTC transactions that would otherwise be excluded from the CEA should not fall within the ambit of the act because they are cleared. If market participants conclude that clearing would reduce counter party risks in OTC transactions, concerns about legal risks associated with the potential application of the CEA should not stand in their way.

The Working Group's report does not make specific recommendations about the regulation of traditional exchange traded futures markets. Nevertheless, it calls for a review of the existing regulatory structures, particularly those applicable to financial futures, to ensure that they are appropriate in light of the objectives of the act. Consistent with the principles of regulation I identified earlier, the report notes that exchange-traded futures should not be subject to regulations that are unnecessary to achieve the CEA's objectives. The report also concludes that the current prohibition on single stock futures can be repealed if issues about the integrity of the underlying securities markets and regulatory arbitrage are resolved.

Mr. Chairman, I want to underscore how important it is for us to address these issues promptly. I cannot claim to speak with certainty as to how our complex and rapidly moving markets will evolve, but I see a real risk that if we fail to rationalize our regulation of centralized trading mechanisms for financial instruments, these markets and related profits and employment opportunities will be lost to foreign jurisdictions that maintain the confidence of global investors without imposing so many regulatory constraints.

My concerns on this score stem from the dramatic advances in information technology that we see all around us. In markets in which there are significant economies of scale and scope, like those for standardized financial instruments, there is a tendency toward consolidation or even natural monopoly. Throughout much of our history, this tendency has been restrained by an inability to communicate information sufficiently quickly, cheaply, and accurately. In recent years, however, this constraint is being essentially eliminated by advances in telecommunications. We have not yet seen clear evidence of the trend toward natural monopoly, but the diffusion of technology often traces a so-called S-shaped curve, first diffusing slowly but then rapidly picking up speed. Once we reach the steep segment of that S-curve, it may be too late to rationalize our regulatory structure.

Already the largest futures exchange in the world is no longer in the American heartland; instead, it is now in the heart of Europe. To be sure, no U.S. exchange has yet to lose a major contract to a foreign competitor. But it would be a serious mistake for us to wait for such unmistakable evidence of a loss of international competitiveness before acting. As our experience with the vast eurodollar markets demonstrates, once markets with scale and scope economies are lost, they are very difficult if not impossible to recapture.

Thank you, Mr. Chairman. I look forward to your questions.

[The prepared statement of Mr. Greenspan can be found in the appendix on page 61.]

The CHAIRMAN. Thank you very much, Chairman Greenspan. Chairman Rainer.

STATEMENT OF WILLIAM J. RAINER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. RAINER. Thank you, Chairman Lugar, Senator Harkin, Senator Fitzgerald. I appreciate the opportunity to come here and discuss these recommendations. The goals of the Working Group report have already been mentioned and the ability to achieve these goals will be enhanced through greater legal certainty for the OTC market. Congressional action to exclude OTC financial derivatives from the act would provide such certainty. I can advocate this step because OTC financial derivatives, as we know them today, do not present regulatory concerns within the scope of the act. Also, excluding this activity will not diminish the CFTC's ability to carry out the statutory mission it is charged to fulfill.

When the Commodity Exchange Act was written, Congress articulated the rationale for regulating futures transactions. First, the act establishes the economic utility of futures trading, stating that futures prices are generally quoted and disseminated throughout the United States and in foreign countries as a basis for determining prices to the producer and the consumer of commodities.

In addition to their price discovery function, futures transactions are used by commercial handlers as a means of hedging themselves against possible loss through fluctuations in price.

The second prong of Congress' rationale for regulation is that the transactions and prices of commodities are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed. The risks of price distortion and manipulation are the factors rendering regulation of these markets imperative. Congress thus identified the overarching public mission of the CFTC as that of preventing price manipulation and ensuring price transparency.

Like exchange-traded futures, OTC derivatives are risk shifting instruments. The Working Group, however, has determined that prices established in OTC derivatives transactions do not serve a significant price discovery role. The Working Group has also concluded that most OTC derivatives are not susceptible to manipulation. Moreover, OTC transactions are entered into and traded by sophisticated institutional traders who are able to look out for themselves in these markets, and as has been pointed out the activities of most derivatives dealers already are subject to direct or indirect Federal oversight.

Because there is no manifest regulatory interest warranting CFTC oversight of OTC derivatives, I support the exclusion proposed by the Working Group. Congress and the CFTC have acted before to resolve legal uncertainty affecting OTC derivatives. In 1992, amid strong signals that swap market participants feared their contracts could be declared unenforceable, Congress responded decisively instructing the CFTC not to regulate swaps entered into by sophisticated parties. Congress authorized the CFTC to provide exemptive relief for swaps without requiring the Agency to make a threshold determination that particular exempted transactions fell within its jurisdiction.

CFTC promptly issued a rule exempting swap agreements from all provisions of the act except prohibitions against fraud and manipulation provided the swaps meet certain conditions. This exemption worked relatively well. Lately, however, evolution in the OTC derivatives market has rendered the exemption inadequate. The exemptive rule does not apply to OTC contracts that are standardized, cleared or executed under conditions that approximate those of an organized exchange.

Technology, however, is dramatically changing the structure and nature of many aspects of the financial services industry. The rise of electronic screen-based trading has blurred the line drawn in our swaps exemption between bilateral and multilateral trading. The growth in swaps volume and the acceptance of these contracts by a wider range of users has led to their standardization. Public policy must meet these advances in the OTC market.

I also believe that development of regulated clearing systems should be encouraged. Clearing systems can employ a variety of risk management tools such as mutualizing risks and offsetting multiple obligations. Consequently, clearing systems can help to reduce systemic risk.

Finally, the commission's rule, the swap exemption rule, exempts bilateral swaps from all provisions of the CEA except those provisions prohibiting manipulation and fraud. The CFTC thought it prudent to retain its jurisdiction to act in the event the Agency learned that participants were engaging in fraudulent or manipulative conduct and that the transactions executed under the exemption were, in fact, futures.

The swaps exemption does not alter the CFTC's responsibility to take action against this misconduct. In a given set of circumstances, however, the Agency's ability to act may be contingent upon proving that transactions are futures or options. This is a critical point to remember. At no time has Congress or the CFTC made the definitive judgment that swap transactions are, in fact, subject to the CEA's jurisdiction. The combination of responsibility with no more than contingent authority is simply bad public policy because as a practical matter the CFTC cannot exercise its residual enforcement authority under the swaps exemption without exacerbating the existing legal uncertainty in this area.

While examining the applicability of the act to OTC markets, we also have conducted an inquiry into whether our current regulatory scheme is appropriately tailored to today's environment for exchange-traded futures. Since November, the Agency has undertaken a serious effort to answer the question what degree of exchange-traded regulation is necessary to serve the public interest entrusted to us?

This inquiry is at the heart of the process that the CFTC has engaged in over the last several months. Impending technological and other changes require the CFTC to scrutinize the continued vitality and viability of its one-size-fits-all regulatory structure that currently applies to all futures transactions. While that process is not yet complete, certain clear principles have emerged.

One, the historic needs of traditional physical commodities should not be the basis for regulating every futures contract traded today and, two, institutional market participants do not require all of the protections designed for retail traders.

The key policy elements will include a move from direct to oversight regulation, a move from prescriptive rules to flexible performance standards, and the increased use of disclosure based regulation. This plan will not impair the Agency's ability to assure the fundamental market integrity expected when conducting futures exchange transactions in the United States or when relying upon the prices set in U.S. exchange-traded markets. The commission will continue to exercise its authority to assure this integrity.

In conclusion, Mr. Chairman, time is not our ally in establishing a framework that achieves our national economic priorities with respect to derivatives trading. Technology has made it increasingly easy to establish rival markets in foreign jurisdictions. Technology has also increased the speed with which new innovations are introduced and widely used by market participants. Because of these realities, I ask Congress to act expeditiously on the recommendations of the Working Group. Thank you again for the opportunity to testify and I will look forward to our continued collaboration with the Working Group and members of this committee and look forward to your questions. Thank you.

[The prepared statement of Mr. Rainer can be found in the appendix on page 68.]

The CHAIRMAN. Thank you very much, Chairman Rainer. Ms. Nazareth.

STATEMENT OF ANNETTE NAZARETH, DIRECTOR OF MARKET REGULATIONS, SECURITIES AND EXCHANGE COMMISSION

Ms. NAZARETH. Thank you, Senator Lugar, Senator Harkin, Senator Fitzgerald. I am pleased today to appear to testify on behalf of the Securities and Exchange Commission as you consider issues pertaining to the reauthorization of the Commodity Futures Trading Commission. In my oral testimony, I will focus on the Report on Over-the-Counter Derivatives Markets and the Commodity Exchange Act, which the President's Working Group on Financial Markets submitted to Congress last November.

In preparing the Report, the Working Group's task was fairly specific: to focus on how the CEA might be modified to address issues related to OTC derivatives markets. Accordingly, the Report makes recommendations in several areas. First, the report recommends that Congress amend the CEA to exclude bilateral swap agreements among eligible swap participants acting on a principal basis. This exclusion would not apply to transactions involving non-financial commodities with finite supplies.

It would also not apply to transactions that are conducted on a multilateral transaction execution facility, as that term is defined by the CFTC. The Commission believes that excluding qualifying instruments from the CEA should create greater legal certainty than the current approach that merely provides for the possibility of exemption, thus leaving open the question of whether such instruments are futures.

Second, the Report explores questions raised when electronic systems facilitate the trading of OTC derivatives. The Report recommends, among other things, that Congress amend the CEA to exclude electronic systems that are clearly not multilateral transaction execution facilities. It also recommends excluding electronic systems that limit their participants to sophisticated counter parties trading for their own accounts, as long as the systems are not used to trade contracts that involve non-financial commodities with finite supplies.

Electronic systems that assist eligible swap participants in communicating about or negotiating bilateral agreements would also be excluded. Moreover, to avoid disadvantaging existing futures exchanges, the Report specifically states that those exchanges would be permitted to establish these kinds of electronic systems for swaps as well.

Third, the Report addresses systems for clearing OTC derivatives. Like electronic trading systems, clearance systems for OTC derivatives are subject to legal uncertainty. Because of their importance, the Report urges Congress to permit regulated clearing systems used for OTC derivatives. The Report clarifies, however, that a clearing system subject to regulation by one agency should not become subject to regulation by another agency simply because it also clears OTC derivatives.

Fourth, the Report focuses on providing greater legal certainty for instruments covered by the Treasury Amendment. The Treasury proposed this amendment in 1974 out of concern that the broad statutory definition of "commodity" would subject OTC markets in government securities and foreign currency to CEA regulation. As a result, the amendment excludes a list of instruments from the definition of commodity. These listed instruments, however, still may be subject to CEA regulation when traded on a "board of trade."

By proposing to replace "board of trade" with "organized exchange," the Report seeks to clearly delineate the limitation on the exclusion. The Report also recommends clarifying the Treasury Amendment to permit the CFTC to address problems associated with foreign currency "bucket shops."

Fifth, the CFTC's "exclusive jurisdiction" over certain matters has caused confusion over the appropriate regulator and regulatory scheme for complex derivative instruments that possess attributes of both securities and futures contracts. In order to provide legal certainty for these hybrid instruments, the CFTC has agreed that it will not propose any new rule that would cover these instruments without the concurrence of the other Working Group members. The Report recommended modifying the CEA's exclusive jurisdiction in order to eliminate questions regarding the authority of the SEC and bank regulators with respect to hybrid instruments. The report also urges Congress to clarify that the Shad–Johnson Accord should not be construed to apply to hybrid instruments that have been exempted from the CEA.

Finally, the unanimous findings of the Report reiterated the commission's position that although single stock futures may possess elements of traditional futures contracts, they also have characteristics of traditional securities. Accordingly, when considering the Shad–Johnson Accord's ban on single stock futures, it is clear that regulatory issues associated with the introduction of such products would be complex. Indeed, the members of the Working Group agree that numerous issues would have to be resolved before the ban could be reconsidered. These issues include, but are not limited to: margin levels; insider trading; sales practices; real time trade reporting; floor broker activities; and CFTC exclusive jurisdiction.

As you know, Chairman Lugar and Senator Gramm have asked the SEC and the CFTC to report back to their respective committees later this month on issues associated with modifying the Shad-Johnson Accord. The Commission staff has been working diligently with their counterparts at the CFTC to consider the relevant issues. We look forward to sharing our views with the Committee on these issues when our report is submitted.

In conclusion, I would like to note that the Report only represents a beginning. In addition to implementing the Report's recommendations, we must all continue to study the rapidly evolving markets for OTC derivatives. With input from Congress and industry participants, we are confident that we may meet any regulatory challenges while permitting this important market to continue to develop efficiently. Thank you.

[The prepared statement of Ms. Nazareth can be found in the appendix on page 73.]

The CHAIRMAN. Thank you very much, Ms. Nazareth. Let me just comment because your very thoughtful testimony touches upon a couple of thoughts. In those you mentioned in one passage that the CFTC would not attempt to act arbitrarily where there are at least arguably issues that face the SEC or other Working Group members and that I like that idea.

As you recall, during the last 2-years as we have come together, there was some question as to whether the CFTC unilaterally would take jurisdiction feeling that it was doing its duty in behalf of the American public and the integrity of the financial system with some dispute of other persons who have come together in this Working Group. Individual members of the Working Group approached this chairman to indicate their distress about that from time to time. So it is important—you know we are all one country, we have one administration, one president who makes appointments—to work together on this. Then the fact that this team effort has come together is significant and that it might be of some value.

Second, each of you have pointed out that time is not our ally in this. When I mentioned in my opening comment that we need to act in the next 3-months, this strikes fear and panic into the hearts of legislators, drafters, all the parties that are involved, to want to approach this in a much more leisurely pace, sort of having several bites at the apple, but I think we all understand I hope the urgency of this. This is why we set some arbitrary deadlines for reports which we are hoping that each of the groups will come back to us.

The third point touched upon by Chairman Greenspan and then amplified by Chairman Rainer, we had during one hearing in this room—in fact, someone sitting about where you are, Ms. Nazareth, demonstrated with a screen here a trade. He actually made a trade in a foreign country from this committee room. I think he sold a contract of corn and got confirmation. That was certainly interesting for all of us who are not involved in day trading here or elsewhere hopefully in the building, but nevertheless it demonstrated the fact that we really do not know all that is occurring. As Chairman Greenspan said, there is an S-curve here. Once you go over the curve, it may be beside the point to deal with all of this with the certainty that we had hoped with regulation. We still have a responsibility to do our best.

But our confidence level probably diminishes rapidly.

But in that respect, do we live in a world, and Chairman Greenspan, I ask you this philosophically, in which it is anticipated by the public that we will all be wise enough to have a regulatory mechanism that brings confidence to our markets and we do our very best to do that? But as I listen to your testimony and sort of read anecdotally the other material, is this a situation that is getting really beyond our abilities to do this? And to what extent, as we approach this, do we do so with some modesty that we do our best but at the same time not give the impression that I think some of us have given in the past that almost like the Food and Drug Administration pinning down safe food and after endless hearings and years of study we get it right? I am not certain this is applicable in this area, but would you give some philosophical perspective to this?

Mr. GREENSPAN. Well, Mr. Chairman, I think you are raising a very important concern. We have been very fortunate in this country that the regulatory structure we have put in place has been generally accepted by the American public. They have exhibited confidence in it, and even though you periodically hear of breakdowns in the system that the press goes a little berserk on in certain areas, what is really quite remarkable is how little of that there is. I do think that we are confronting a broader challenge to continue that level of integrity of our system largely because, as I point out in my prepared remarks, the technology of financial innovation has become so extraordinary, and, in many respects, almost discontinuous.

We have seen quantum jumps in information technology in the nature of financial products, and as a consequence, the need for financial regulation to adjust itself to the rapidly altering financial structure which confronts us. I think the Working Group has endeavored in this particular area to recognize that a number of our definitions and our concepts with respect to financial instruments generally, and derivatives particularly, have got to be understood in a rapidly changing environment.

I cannot promise you nor do I believe any of our colleagues can that we will get this all right. But I do say, and I think it should be emphasized, that the Working Group works very effectively. I am myself impressed at the interaction that has occurred and our ability to reach consensus. We do that not because each and every member of the group agrees wholeheartedly with each and every recommendation, but we recognize the need for consensus above the specific solutions that each of us would prefer, other things equal, and I take that as a very good sign.

The CHAIRMAN. I can remember just anecdotally, Chairman Greenspan, your coming along with Secretary Rubin to Senator Dole's office at the beginning of the Mexican crisis, now I guess 4-years ago or so—five—time goes by rapidly.

Mr. GREENSPAN. But memories do not fade.

The CHAIRMAN. I know. The thing that I remember about the meeting, however, is the description of billions of dollars being electronically transferred, not just with regard to Mexico and the United States, but as you were pointing out at that time from Southeast Asia and strange places that we would not have thought were necessarily involved in a bilateral crisis but at the same time seeking safety presumably. I think this was impressive that unlike most types of protectionism, where you can try to keep out something or keep it in, with regard to money and electronics, even at that point, and as you say quantum leaps have occurred in that 5-year period. So that this is something to say the least that is very difficult, but it is reassuring and I like your comment that the Working Group has gotten together. Hopefully without knowing this is a permanent institution, there at least is enough tradition of your working together which is extremely helpful to the relevant committees.

In that point, I am trying to work together, and I made explicit this morning, with Chairman Gramm of the Banking Committee. As we have gotten through the CFTC's situations during the last two decades or so in which I have been involved in this, frequently we have been in loggerheads with the Banking Committee or we have gone through several years in which nothing happened because there was sufficient stymie either way. I think Chairman Gramm is determined, and I am, that we have oversight over different institutions, but nevertheless we have a working group in which you have bridged those gaps in the administration, and I know the distinguished ranking member joins me in our attempts to bridge them in this Senate, bipartisan and by committee or whoever else we need to work with.

In that respect, Chairman Rainer, let me ask you, you have talked, and Senator Harkin asked a very pertinent question about the difference between exemption and exclusion, but you have said exclusion, and you have said it because this gets to the heart of the legal certainty problem. You talked about a regulatory scheme that really did not seem to be quite focused. It never quite had the authority. It was out there, however, and a part of the crisis that brought us all together a couple of years ago was that suddenly CFTC, vague or not, decided it was in the public interest that unilaterally it would deal with this problem.

So this then threw markets into potential turmoil. I do not want to put too fine a point on it, but this is a very important juncture in the legislation and would you just underline again the need for either certainty, exclusion as opposed to exemption, how this fits after all the studies and compromises that you may have made?

Mr. RAINER. That is a very important question, Chairman Lugar, and not one that I have not spent a considerable amount of time thinking about. The first thing I did was to determine whether I agreed with everyone else in the Working Group whether or not the instruments of the over-the-counter derivatives were not manipulable, did not serve a price discovery role, and the impact of the types of participants with respect to regulation. I have satisfied myself that these instruments are not readily susceptible to manipulation and do not serve a meaningful price discovery role. As a result of that and given the sort of collision that the CEA and the over-the-counter derivatives market has more or less been on for a long time, I thought it was time to resolve this matter, to resolve the issue. I thought it was in the public interest to get this cleared up and I did not see the benefits of the Commodity Exchange Act superimposed over this market.

The CHAIRMAN. Those are the two major criteria, manipulation and——

Mr. RAINER. Serving a price discovery role.

The CHAIRMAN. And price discovery.

Mr. RAINER. Since those two elements are not material with this market, I thought that the public interest would be best served if I agreed that we exclude this market from the Commodity Exchange Act. Exclusion versus exemption—that is not a complicated answer for me. I was seeking the greatest clarity for legal certainty and an exemption would provide clarity. A codified exemption would probably provide a little more clarity, but the greatest clarity would be an exclusion, and I support that.

The CHAIRMAN. Thank you. Senator Harkin.

Senator HARKIN. Thank you, Mr. Chairman. I had three questions. That was one of them, and that is can we provide the same kind of legal certainty—after all, we write laws—and to provide the same kind of legal certainty under an exemption that we can under exclusions? I do not know why we cannot do that. Again, I get back to what I asked Secretary Summers in the beginning. That with an exclusion we have washed our hands of it. If anything happens, again, you say I do not know what is going to happen out there. I mean you say there is a notional value of about $83 trillion or something like that worldwide. I mean that is a lot of risk out there. These are risk instruments. That is a lot of risk.

And so if you have this exclusion and something unforeseen happens, who does something about it? You cannot, Mr. Chairman. You cannot. You cannot. It has got to come back to us and we do not act that fast around here. So I am wondering that within the framework of an exemption, can you provide the legal certainty which I understand has to be done, and this is what I wrestle with, the legal certainty of these contracts, but keeping the hammer—I do not know—hammer may be the wrong word—but keeping the possibility that one of you or all of you can act rapidly to intervene at some point? I ask all of you that. I will start with you.

Mr. RAINER. I will defer on some of these matters to Chairman Greenspan, but one of my answers is that I think we have to keep in mind that most of these participants are either involved in the banking system or investment banking industry and so there is regulation along those lines. I am not a lawyer and I cannot slice the differences very well between codified swap exemption and exclusion, but I have been assured that exclusion does provide the greatest clarity for legal certainty. And, if that is the case, that is what I am supporting.

Senator HARKIN. Well, I have been told that, too, but I am not certain I am buying it right now. I may. Chairman Greenspan.

Mr. GREENSPAN. Senator, let me repeat what Secretary Summers says because I do agree with him on this. The problem would be less immediate if the CFTC had 20-year terms for Commission members, and the people in the CFTC stayed very long periods of time and did not change their philosophy particularly. Then the issue would be pretty much irrelevant, I would think. That is not the case. We have changing CFTCs. Indeed, the difference between the current CFTC and the one immediately preceding it with respect to how the CFTC viewed the markets is really quite significantly different.

The result of that is that you have a situation where the uncertainty owing to the turnover of the commission does create a significant diminution of the degree of legal certainty, and I think that a major concern is that it is a critical issue which unless appropriately resolved can very readily move a very substantial part of this market, and it is a huge market, as you point out, overseas. There is virtually no reason why a lot of these transactions that are made by larger investors cannot be struck in London under a different set of laws.

So I would just say basically that because of the easy ability to move abroad, it means that the sensitivity or the particular barrier which we have to cross with respect to degrees of uncertainty has been lowered, and I am fearful that unless we get legal certainty, and indeed it is the view of all of the Working Group members, we are fearful that we may end up with another eurodollar market.

Senator HARKIN. I try to interpret in my own words. Maybe I just wanted clarification of this, Mr. Chairman. It almost sounded to my ears like you were saying that if we were—if in the wisdom of Congress, we were to provide some kind of legal certainty to these derivatives and do it under an exemption basis, that the regulatory body that would be best able to oversee that would not be something like the CFTC, which as you say changes more rapidly, but perhaps something like the Federal Reserve System which is more stable and long term.

Mr. GREENSPAN. I would say that even we do not, in my judgment, fall into the category which would create the same degree of legal certainty that a statute would do. I——

Senator HARKIN. Are my fears unfounded then that if something happens out there, there is no one that can do anything and we have to act here in Congress? Is that just an unfounded fear or——

Mr. GREENSPAN. Senator, no, you are certainly raising a legitimate question which really is far broader than the question of the issue we are discussing today because all of government regulation is either discretionary with respect to various regulatory agencies or prohibitive. There is no capability of any element within this government, for example, to regulate home heating oil prices, to my knowledge. When we had this recent very sharp run-up in prices, there indeed was no authority to deal with it. It is a market adjustment process which will eventually deal with it and, as I think we have all argued, in the derivatives area, it is largely counterparty surveillance which is our primary source of regulation.

I think that we have to recognize that regulation is a very difficult operation. I mean you point out that the LTCM episode was one over which we had no particular regulatory capability, yet the supervisory structure of this government worked. We had an ad hoc approach. The Federal Reserve Bank of New York brought together numbers of private parties because in our judgment it was to their interest to resolve the question. There is a great deal of that going on.

Can I envisage a problem that will emerge in which if there had been regulatory authority, it would have been readily resolved and that we in the event did not have that authority and would be presumably worse off? Absolutely. I mean those are going to happen. I think that there is a very fundamental tradeoff of what type of economy you wish to have. I mean you can have huge amount of regulation and I will guarantee nothing will go wrong, but nothing will go right either.

Senator HARKIN. My time has run out. I do not know if Ms. Nazareth wanted to wade into this or not.

Ms. NAZARETH. Well, just briefly. I certainly agree with Chairman Greenspan and Chairman Rainer that there are very strong benefits to the legal certainty. I also think that there, in fact, have been a number of improvements and private sector initiatives in addressing the risks associated with this business. The improved transparency initiatives that came out of the President's Working Group Report on Highly Leveraged Institutions I think was very important. I do think that market discipline has been and will continue to improve significantly.

I think credit standards have improved and, you know, as a result of the Working Group's Report on Highly Leveraged Institutions, we will probably see greater transparency of exposure to highly leveraged institutions and also the SEC asked for increased risk assessment authority. So there are other initiatives going on that I think will go to improving the issues of the systemic risk.

Senator HARKIN. Thank you. Mr. Chairman, I had two other, but obviously I have used up my time. The other two, and I may just write these in a letter to you all, number one, the exchanges are concerned about parity. In other words, they are looking for some regulatory relief, too, and if we do this and we do not do the other one, they are worried about the disconnect. I think that is a fair, rational concern on their part, and I wanted to ask you about that, but maybe I will in a letter.

The other one was just on the clearinghouse concept. I am not certain how that works in this regime. I know how it works on the exchanges where you settle up and you make your marks everyday and you clear it at the end of the day. I do not know how it works in this setting and, again, perhaps in a letter you could outline it for me how this clearinghouse concept might work. Thank you, Mr. Chairman.

The CHAIRMAN. Let me just respond for a moment. Senator, in my opening comment I mentioned that, just taking up this parity situation comparable problems with SEC or others. Chairman Gramm and other members of the Banking Committee have suggested and I think this may be a good idea that we may have joint hearings of the two committees.

Senator HARKIN. That would be good.

The CHAIRMAN. To try to take a look at the level of regulation so that things do not get too disparate. We do not have a comparable situations entirely, but some members of the Banking Committee including the Chairman are much interested in this question, too. So this may be a way on our side at least of trying to do work that is comparably done by the Working Group. Senator Fitzgerald.

Senator FITZGERALD. Thank you, Mr. Chairman. I have a question for Ms. Nazareth. I appreciate your being here and I gather you are the Director of Market Regulation at the SEC.

Ms. NAZARETH. That is right.

Senator FITZGERALD. We talked with Secretary Summers about how well our securities laws have worked in this country and I think we have a wonderful regime that has held up well even though it was drafted in the 1930s. It has held up well even in this modern world. One feature of our securities laws in this country is that the basic core statutes apply to all securities traded everywhere. There are some minor exceptions to that general rule. One can sell stock to sophisticated parties without filing a registration statement. However, in general, if there were ever any fraud, you would come in under your authority under section 10(b)(5) and wherever that market trading occurred, whether it occurred on an exchange or out in the parking lot, you would have the authority to act.

Furthermore, the definition of securities in the securities laws of this country is very, very broad. It is hard to create a financial product that does not have characteristics of a security. In fact, stocks, bonds, promissory notes can be classified as securities, and the scope of the securities laws is enormously broad, very hard to escape. The laws apply everywhere.

In talking about how we are going to redo the CEA, we are talking about something completely different. Instead of having a CEA that applies to all financial derivatives everywhere and equally and having a broad definition of what is encompassed by the act, we are really carving out a little narrow area of financial derivatives that are going to bear the whole brunt of full-scale regulation; namely financial derivatives that are called futures contracts and traded on an exchange.

Anything that is slightly different that can be called a swap as opposed to a future. An interest rate swap, if we call it a swap, even if it is fungible, standardized, and not traded on an exchange, it will not be subject to regulation. I am just wondering if that makes sense. Do you not think there is a possibility that all financial derivatives the business is going to migrate to the swaps area very easily because you can escape the definition of what is covered by the act?

In fact, what is covered by the act is left really to something that is labeled a future and traded on an official board of trade. Do you not think a lot of that business is just going to go to where it is unregulated? In addition do you think our securities laws should have such kind of gaping exemptions and just apply in little narrow areas?

Ms. NAZARETH. I would not think that it would all migrate to the over-the-counter derivatives markets because those are—they are really not standardized products. They are bilateral contracts. They are not fungible. They are used really for very specific financial purposes.

Senator FITZGERALD. You do not think there is any standardization of interest rate swaps out there? I mean——

Ms. NAZARETH. Well, I think given the large market for them, there certainly has become somewhat more of a standardization in the sense that there obviously are agreements that people use, but they do negotiate the terms of those agreements on a bilateral basis.

Senator FITZGERALD. How would you describe the difference in economic terms between an interest rate swap between institutional parties and institutional parties buying interest rate futures? What is the economic difference between those two transactions?

Ms. NAZARETH. Well, there are differences in—again, I think there are differences in the fungibility, the closeout procedures. Currently certainly there were differences in the ability to net. There will be some more—they will become——

Senator FITZGERALD. But what are the economic differences? Suppose we have a different futures contract for every interest rate swap. We change the contract in some regard so it is no longer fungible. What would be the economic difference?

Ms. NAZARETH. Well, I think in some cases they may serve a similar economic function. I think that is one of the challenges that we all have as regulators today is that you have a number of these products that start to resemble each other.

Senator FITZGERALD. What would be the public policy rationale for giving disparate treatment to similar instruments traded by similarly situated institutions, but just happen to be trading in different venues?

Ms. NAZARETH. Well, I am not here to sort of argue what I believe is, you know, Chairman Rainer's jurisdiction with respect to what should the commodities laws cover, but I do think that there are differences in that what we have done for purposes of this report is simply address over-the-counter derivatives and defined them, defined these swap transactions in a narrow way of just talking about counter parties with $25 million in investments, bilateral contracts, contracts that are done purely on a principal basis. So it is a smaller subset. Certainly it does not cover, you know, retail products and things of that nature.But again I think——

Senator FITZGERALD. Would anybody else care to address this issue? It seems to be a distinction without a difference.

Mr. RAINER. Senator Fitzgerald, you raise very good points and I think it is very consistent with what is actually in the Working Group set of recommendations because there is difference paid to the fact that these recommendations may have an impact on our exchange-traded futures with differences in regulation for similar products. One of the reasons I think we have such a good strategy here is because this is not a one-part recommendation, it is a two-part recommendation.

The first part is to enact the recommendations with respect to the over-the-counter derivatives and the other part is for the CFTC with assistance from this committee and others to devise a regulatory framework that is more rational than the one that we have today. With your example, if I were to say eurodollar contracts, I would argue, although we have not made this judgment officially, I would say there is a good case to be made that the eurodollar contract is also a contract that is not readily susceptible to manipulation. Our challenge is to come up with a comprehensive framework that deals with the very issues that you were talking about.

Senator FITZGERALD. Thank you. Mr. Greenspan, the Federal Reserve Board regulates the banks in this country and I am sure you have been looking very carefully at——

Mr. GREENSPAN. Some of the banks.

[Laughter.]

Senator FITZGERALD. Well, all bank holding companies.

Mr. GREENSPAN. Correct.

Senator FITZGERALD. You do look at the derivatives on the balance sheets, the derivative exposures of our banks. A lot of banks have purchased interest rate swap contracts. In fact, I saw that of that 80-trillion on OTC financial derivative markets, a large percentage of that are simply interest rate swaps, I would imagine most of those swaps are between financial institutions laying off interest rate risks that they may have. Have many banks bought interest rate futures on a board of trade or are they all interest rate swaps?

Mr. GREENSPAN. There is both involved, but I think the point you are making, which I would agree with, is the fact that the proportion of derivatives which are exchange traded has been declining, and the reason they have been declining is that the market participants perceive that the costs of exchange-traded derivatives exceed the benefits that they create over and above over-the-counter derivatives. And, they do. I mean there are certain advantages in the settlement and clearing processes in exchanges which are not replicable in the over-the-counter markets and as a consequence the exchanges do have certain benefits which the OTC markets do not have.

If, however, we see, as we do, a decline in the share of exchange-traded instruments, it presumably means that the markets generally perceive that the costs involved, essentially regulatory costs, are excessive relative to the benefits that are achieved. I think that it clearly is an issue that ought to be addressed. We at the Working Group certainly are aware of this problem and have been looking at it. And, precisely how to come at it, I think is an issue which does require efforts on our part and I would presume that we will be moving in that direction as best we can.

Senator FITZGERALD. Would you be in favor of exempting exchange-traded transactions wherein the counterparties are strictly institutional?

Mr. GREENSPAN. There has been a considerable amount of discussion and indeed certain efforts beginning to be directed in that particular area. Obviously, the concerns that a number of people have is that if you bifurcate the market, you will create a significant spread in at least part of the residual. That, is the bid-asked spreads will open up because the volumes will be substantially less.

I do think we have an issue here that has got to be resolved and I would suspect that it is not so much an exchange issue as it is between retail customers and institutional customers. There is no question that if you have a very large volume market, the liquidity of that market will essentially create a very significantly lower per unit cost of transaction than you will get in a retail market, which by its nature is much smaller.

The question is whether or not you want to do cross-subsidization between these various types of markets. My own impression is that if you were concerned about this issue, one vehicle which we used to have, I guess, was in the grain pits. We used to have, I remember, thousand bushel wheat contracts. A thousand bushel wheat contract had a bid-asked spread which was significantly wider than the conventional 5,000-bushel wheat contract. But you had a considerable volume of retail business in the thousand bushel contract and what would happen would be is that the exchange traders would arbitrage the difference and effectively, significantly reduce the difference in the spreads, but not completely.

In other words, they did not effectively cross-subsidize because that was not their business, but their arbitrage did bring down the differences quite considerably and I think what the issue here is not that we do not perceive of the necessity of making certain that retail markets are as efficient and liquid as they can be, but how do we do it without impairing the important competitive efficiencies of the large institutional markets. That is where the issue lies as far as I can see.

Senator FITZGERALD. We have not bifurcated our securities market like that.

Mr. GREENSPAN. Well, we used to have odd lots, remember. It was the same issue.

Senator FITZGERALD. OK.

Mr. GREENSPAN. I as a kid used to buy odd lots and some of them were very odd stocks, I must say.

[Laughter.]

Senator FITZGERALD. Well, thank you very much. I appreciate that testimony. I have just one question on the Treasury Amendment, if I may? I know we have run over, but the report adopts a definition of organized exchange that has two parts. One, it permits retailer agency trades and, two, it provides for self-regulation. Under the proposed amendment to the Treasury Amendment, could an exchange which is open to retail customers and which trades Treasury Amendment products other than foreign currencies opt out of the CEA simply by either dropping its self-regulatory functions or barring the retail customers?

Mr. RAINER. Is that to me, Senator?

Senator FITZGERALD. Yes.

Mr. RAINER. That is a very complicated question and I would like to answer it this way. The Treasury Amendment is in need of repair. The CFTC has a mission where it should and does find and prosecute and convict entities involved with foreign exchange on retail. This is a large problem in our country. The way it works is that for the CFTC successfully to prosecute such an entity, it must prove that entity is a board of trade. And the way it proves, at least one way it proves that it is a board of trade, is define the board of trade under the category called "association of persons." If it is an association of persons, it is easier to establish that this bucket shop is a board of trade. That very act if successful has the Catch-22 effect of potentially looping in legitimate bond dealers into the CEA, an unintended circumstance.

So I think what the PWG is trying to solve is this problem by converting the definition to organized exchange with retail and SRO. I do not care to give full validity to your example, but it is not intended, I do not think, to allow your example to happen, and this is one of these technical details that we will be happy to work with the Committee on.

Senator FITZGERALD. Once you write the legislation, will you come up with the way of solving it?

Mr. RAINER. Yes.

Senator FITZGERALD. Well, thank you all very much. Appreciate your time.

The CHAIRMAN. Thank you very much, Senator Fitzgerald, for comprehensive questions and we thank each of you for giving us your testimony and your service. This panel is dismissed.

The CHAIRMAN. We will proceed on to the final panel which will include Mr. David Brennan, Chicago Board of Trade; Chairman Daniel Rappaport of the New York Mercantile Exchange; Mr. Jerry Salzman of the Chicago Mercantile Exchange; Mr. Richard Grove, Chief Executive Officer of the International Swaps and Derivatives Association; and Mr. Edward Rosen, counsel, Ad Hoc Coalition of Commercial and Investment Banks.

The Committee will come to order. It is a privilege to have each of you gentlemen here this morning for your testimony and I will ask that you testify in the order that I introduced you and that would be, first of all, Chairman Brennan, then Chairman Rappaport, Mr. Salzman, Mr. Grove and Mr. Rosen. If you can, try to summarize your testimony in 5-minutes and all of your statements will be made a part of the record so it will not be necessary for you to ask that, that occur. It will occur because we want a complete record of your views and the entire hearing. Chairman Brennan, good to have you again before the Committee.

STATEMENT OF DAVID P. BRENNAN, CHAIRMAN, CHICAGO BOARD OF TRADE ACCOMPANIED BY THOMAS R. DONOVAN, CHIEF EXECUTIVE OFFICER AND PRESIDENT, CHICAGO BOARD OF TRADE

Mr. BRENNAN. Thank you, Senator, and thank you for having me. Mr. Chairman and members of the Committee, I am David Brennan, Chairman of the Chicago Board of Trade. With me today is our President and CEO Tom Donovan. We thank you for the opportunity to discuss with you the Working Group's report on derivatives markets.

Before I begin, I would like to mention that the new leadership at the CFTC, Chairman Bill Rainer, has been a breath of fresh air. He has brought market experience and creativity to the Agency. As you have already heard this morning, under Chairman Rainer, the CFTC is looking to transform and modernize its regulatory approach. We applaud his efforts and look forward to working with him.

We have submitted to this committee a written statement that describes in detail where we agree and disagree with the Working Group's report. Sometimes in all that detail the big picture does get lost. I want to make sure that I emphasize that picture today.

The Working Group's recommendations add up to a comprehensive overhaul of the Commodity Exchange Act. Broadly stated, the Working Group's framework would do three things: give legal certainty to over-the-counter derivatives; transform the CFTC into an oversight agency for execution and clearing facilities; and reconsider the single stock futures ban in Shad–Johnson and its competitive implications.

Chicago Board of Trade fully endorses the need to reform the CEA and the Working Group's three-part framework. That should not be too surprising. Restructuring Federal regulation is driven by the same market forces-technology, globalization, innovation and competition-which have caused exchanges to restructure themselves. The Board of Trade is no exception. This last month our board of directors overwhelmingly adopted a bold strategy to restructure our exchange by creating two independent for-profit companies. One will focus on pit trading; the other will focus on trading electronically. Both will try to attract business by providing liquid trading markets. Both will innovate and invest in technology to provide customers the best service. Both will provide customers with a market that they can trust.

What our plan does is give both companies a fair chance to compete, and no business should really ask for more. Federal regulation is part of that fair chance. We believe in open markets and fair competition. To us, similar products traded in similar circumstances should have similar government oversight. That means privately negotiated transactions may be excluded, but all public execution facilities should be treated alike. That is our "golden" rule of fair competition.

Today that rule is not being met. After almost 80-years, the Commodity Exchange Act has become unworkable. Over-the-counter derivatives, especially in the area of equity swaps, are plagued by legal uncertainty, as the Working Group describes. Exchange markets suffer from extreme regulatory arbitrage, as the Working Group acknowledges. For single stock futures, it is even worse. We are barred from competing at all under a statutory provision that we were told 18-years ago would be "temporary" until a regulatory impasse could be resolved.

The Working Group recommendations cover each of these areas. Some of those recommendations are specific statutory changes. Some involve working with the CFTC and the SEC. We know that many details need to be worked out and are likely to be controversial, but we are eager to help bring these issues to closure. Mr. Chairman and members of the Committee, all we have ever asked for is a fair chance to compete. This year's CFTC reauthorization may present us with our best chance to achieve that goal. We look forward to working with you and this committee to make sure that, that common objective becomes a legislative reality. Thank you very much.

The CHAIRMAN. Well, thank you very much, Mr. Brennan, and we look forward to working with you and your associates in the Chicago Board of Trade. We noted with interest the developments that you described there in your organization which are indicative of some of the issues that have been a part of this hearing today.

[The prepared statement of Mr. Brennan can be found in the appendix on page 81.]

Chairman Rappaport.

STATEMENT OF DANIEL RAPPAPORT, CHAIRMAN, NEW YORK MERCANTILE EXCHANGE

Mr. RAPPAPORT. Thank you, Mr. Chairman. Thank you, Senator Fitzgerald. I had a number of comments that I was going to make but I will not make, and I think I will keep my comments relatively brief because I cannot tell you how encouraged I was sitting out in the audience listening to your questions to the other panels and after coming and going to these hearings over the last 7-years for the time that I have been chairman of the New York Mercantile Exchange, I see that finally we have gotten our point across because you are asking the questions that we were asking years ago coming to you trying to make you aware of this disparity of regulation, this inequitable disparity of regulation that did not put us on a level playing field with a marketplace that was selling the same product to the same customers at the same exact time, and we really appreciate the fact that you are beginning and clearly now understand this issue.

We think that while the Working Group report begins to address some of the issues associated with legal certainty and some of the other related issues, I was very glad to hear your comments in terms of this is really only half the puzzle and that the other half of the puzzle needs to be resolved and that you have an interest in resolving it in more of a simultaneous manner than some other people are discussing, not permitting our side to be held hostage to resolution of this other issue because, as you recall, when Congress passed the Futures Trading Practices Act in 1992, they also encouraged that the commission use its exemptive authority to take care of the exchange issue. Here we sit 8-years later not having got any real relief, although I will echo Chairman Brennan's remarks that Chairman Rainer's initiatives in this area in a very short time have made incredible accomplishments and we look forward to more.

But even the report itself says that U.S. futures exchanges, on page 21, are at a competitive disadvantage to OTC derivative markets as a result of the Commodity Exchange Act observing what major market participants have said and the report itself goes on to say that if the recommendations in the report are implemented that they hold out a good possibility that it will only exacerbate that perceived balance. And, that is really where we are today. We are here to say that we agree with some of the recommendations in the report. We are looking forward to seeing the commission's response to the rest of the puzzle and I look forward to being here again to talk to you more about that. Thank you.

The CHAIRMAN. Well, thank you very much, Chairman Rappaport. As you know, we have asked for specific comments on issues that we are not taking up in great detail today from the chairmen of CFTC and the SEC and in a fairly short time frame because these are relevant clearly and I have stressed again the potential cooperation with Chairman Gramm and the Banking Committee. You cite correctly the 1992 act is one in which some cooperation came only have a long stretch and so we are back, at least——

Mr. RAPPAPORT. It did not really come to us though.

The CHAIRMAN.—into a different report at that point.

[The prepared statement of Mr. Rappaport can be found in the appendix on page 92.]

Mr. Salzman.

STATEMENT OF JERRY SALZMAN, CHICAGO MERCANTILE EXCHANGE

Mr. SALZMAN. Chairman Lugar and Senator Fitzgerald, I am honored to represent the CME's Chairman Scott Gordon who was unfortunately too ill to get on the plane last night or this morning. He sends his regrets to this committee. I am going to essentially present his remarks, if I may, and, of course, as usual I may add something of my own. I want to begin by unequivocally expressing the CME's support for the efforts of the CFTC under Chairman Rainer to reexamine and reassess the regulatory structure of our industry. The commission has made valiant initial revisions to its very thick white book of regulations. We think that demonstrates the commitment to bring regulatory burdens into line with regulatory needs. We are extremely happy about that.

That said and without criticism of our Regulator's endorsement of the President's Working Group's Report, it is fair to say that the CME is extremely concerned about the focus of that Report. We are, of course, heartened by Senator Lugar's remarks that he is going to ensure that we get some parity when legislation is put into place. But it is clear to us that the Report itself unjustifiably tilts the playing field against the existing exchanges.

Our goal, the goal of the exchanges, has been equivalent regulatory treatment for functionally equivalent execution facilities, clearinghouses, and intermediaries. That is, if an execution facility is performing a function, all execution facilities performing the same function in an equivalent manner should be treated equally. Same for clearinghouses and the same for intermediaries. We have carefully assessed the Report and we do not think that the Report endorses this principle. The Working Group has recognized the regulatory disparities and blurred product distinctions that handcuff U.S. futures exchanges in today's competitive global markets. I think Senator Fitzgerald's questions have been very pointed in saying what is the difference between these products? What are the differences between the intermediaries? What are the differences between these end users in these two markets? That has really called the issue into a clear perspective.

We consider that omission in the Report a serious flaw. Now the Report does call for some changes that are in accord with our principles. But it's recommendations for regulatory relief and legal certainty we think are only going to bring immediate benefits to the over-the-counter market and to enterprises that are now springing up all over this country intending to operate or operating unregulated exchanges at this very point in time. All you have to do is look on the internet or look in the newspaper clips everyday. There is a new one every morning.

The Report itself begins with what I think we would all agree is a conservative call for legal certainty for the over-the-counter swaps market. We agreed with that call and we sponsored and have made proposals to that effect beginning early last year. The Report, however, veers from that simple principle to a more radical realignment of markets and regulators by essentially redefining what a swap is to include standardized, cleared, financial futures contracts that are traded on electronic exchanges. So effectively, while calling for legal certainty for a swap, they then redefine swap and call for special treatment for special kinds of exchanges that essentially duplicate what our exchanges are doing.

The call for legal certainty for a bilaterally negotiated swap contract, which we support, is effectively converted into a demand for exclusion from the CEA for exchange traded and cleared financial futures. Now this creates two problems. Senators Harkin and Fitzgerald have pointed out that the exclusion may cripple somebody at a later point in time when action needs to be taken and it is not clear why you need an exclusion.

There is another problem that I do not think has been raised, except in our testimony, which is that the exclusion may not lead to the legal certainty. Legal certainty has been code for avoidance of CFTC regulation and risks of equities or derivatives that have underlying securities from the CEA. Given the public statements of the SEC and the statements and briefs that they filed in many courts, there becomes a serious question as to whether these excluded derivatives are or are not securities. As Senator Fitzgerald has noted, given the broad scope of that definition and given court decisions that the only reason they are not securities is because of the CFTC's exclusive jurisdiction.

My concern is that we are not creating legal certainty but transferring uncertainty from one regulator to another regulator. I think this issue has to be faced at a very early stage in this process. I see my red light is on. I have a little more, but I do not want to hog time up here so I will just stop.

The CHAIRMAN. Proceed if you can summarize.

Mr. SALZMAN. OK. I want to draw special attention to a discrepancy between the treatment that the OTC market gets in the Report and exchanges that is in respect to equity derivatives. As we all know, the Shad-Johnson accord raises questions as to legality of both exchange-traded single security futures and over-the-counter single security futures or derivatives. The President's Working Group proposes to exclude swap agreements that "reference non-exempt securities from the CEA." Non-exempt securities, I believe, is a term of art for equity securities and certain kinds of other municipals and things like that.

In fact, the Presidential Working Group urges that single stock futures and all stock indexes be permitted both over-the-counter and on the unregulated exchanges it describes. If that reccomendation were enacted, we would be in this strange situation where the places to trade derivatives on single-stock futures are either over-the-counter or unregulated markets. A regulated market with transparent pricing and careful protection of ultimate customers is the only place left where you cannot trade the instrument. That proposal is made without any suggestion that we have to work out regulatory issues, where we have to work out margins, where we have to work out anything.

In fact, it is just carte blanche for unregulated exchanges and over-the-counter markets and the same old story for the existing regulated markets. This to us does not seem reasonable or fair. And with that, I will stop. Thank you very much, Senator.

[The prepared statement of Mr. Gordon, submitted by Mr. Salzman can be found in the appendix on page 100.]

The CHAIRMAN. Well, thank you, Mr. Salzman. Let me mention at this point two things. First of all, I should have mentioned that Commissioners David Spears and Jim Newsome have come to the hearing today from CFTC and we appreciate their presence in addition to the distinguished chairman.

The other thing is that Senator Fitzgerald and I will need to go to vote. There are 5-minutes left in the roll call on the bill that is on the floor. Fortunately, it is a single vote and so I will ask the patience of Mr. Grove and Mr. Rosen because we will both want to hear the testimony from the beginning.

Senator FITZGERALD. We will be right back.

The CHAIRMAN. We will be right back. The hearing is recessed for a moment.

[Recess.]

The hearing is called to order. We look forward now to the testimony of Mr. Grove. Will you please proceed?

STATEMENT OF RICHARD GROVE, CHIEF EXECUTIVE OFFICER, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION

Mr. GROVE. Thank you very much, Mr. Chairman. I am the CEO of ISDA, the International Swaps and Derivatives Association, and before joining ISDA, I was actively engaged for many years in sales and trading of OTC derivatives and other financial products. ISDA has had the privilege of appearing before and working with this committee for more than a decade and we are pleased to be here again today. ISDA's more than 450-members include the world's leading dealers in off-exchange principal-to-principal derivatives transactions. These transactions are typically referred to as swaps and their status under the CEA is the focal point of the report of the President's Working Group.

Swaps, as you know, Mr. Chairman, are powerful tools that enable American businesses and other end users in each of the 50-states to manage the interest rate, currency, commodity, credit and other related risks that are inherent in their activities. In this way, businesses and other users of swaps are able to lower their cost of capital, manage their credit exposures and increase their competitiveness both here and abroad by focusing on their core areas of expertise.

The United States has been a leader in the development of swaps and American businesses were among the earliest to benefit from these risk management tools. The dramatic growth in the volume and diversity of swaps is probably the best evidence of their importance to, and acceptance by, end users. It is no coincidence that the U.S. economy and the volume of swaps both grew dramatically during the last decade. Let me add at this point that ISDA's membership includes many of the businesses, financial institutions, government entities and other end users that rely on swaps to manage their financial and commodity market risks with a degree of efficiency and effectiveness that would not otherwise be possible.

The Working Group report is the product of a great deal of effort by each of the members of the group and their colleagues. It reflects a solid understanding of, and sensitivity to, the factors that enable the U.S. financial markets to so efficiently allocate capital and so effectively sustain economic growth. The report embodies an unprecedented consensus among four key financial regulators that legislation should be enacted to provide legal certainty for swaps.

As you know, legal certainty simply means that parties, both dealers and end users, must be certain that the provisions of the swaps agreements they enter into are enforceable. Any uncertainty with respect to the enforceability of swaps creates risks not only for parties involved but for the financial system as a whole. For example, when unilateral actions by the CFTC in 1998 suggested that the CFTC might treat some swaps as futures contracts, congressional action was required to preserve legal certainty for swaps and thus ensure continued market stability.

The underlying policy considerations were not addressed by Congress in 1998, but they have now been carefully considered by the Working Group. The Working Group concluded that financial swaps do not present public policy concerns of the sort that the CEA is intended to address and that legal certainty can therefore best be provided by an exclusion from the CEA.

In one respect ISDA believes that Congress should go further than the Working Group by excluding from the CEA swaps involving commodities with deep and liquid markets such as various energy products. Indeed, the failure to do so may stifle the continued development of innovative energy risk management tools in the United States to the detriment of American businesses and other end users. That having been said, ISDA agrees with the thrust of the Working Group's recommendations. There is broad consensus on the merits of the issue and I cannot emphasize too strongly ISDA's belief that the time for congressional action to provide legal certainty is now.

I would also stress that legal certainty should be provided in a manner that does not restrict financial innovation. As you know, Mr. Chairman, U.S. financial institutions and U.S. technology companies are world leaders in their respective fields. From the broad perspective of our national interest, we should not compromise these leadership positions by creating or maintaining regulatory structures that discourage financial institutions from using and benefiting from the most efficient and innovative electronic technology available.

To summarize, ISDA hopes that the Working Group's report will serve as the catalyst for the enactment of bipartisan legislation this year to provide legal certainty for swaps. As described more fully in our written statement, ISDA believes that this legislation should also provide appropriate regulatory relief for the futures exchanges.

Let me conclude with the promise that ISDA will remain committed to working with this committee on a cooperative and constructive basis to ensure that the key objective of legal certainty for swaps as well as appropriate regulatory relief for the futures exchanges is translated into legislative reality this year. Thank you, Mr. Chairman.

[The prepared statement of Mr. Grove can be found in the appendix on page 106.]

The CHAIRMAN. Thank you very much, Mr. Grove. Mr. Rosen.

STATEMENT OF EDWARD ROSEN, COUNSEL, AD HOC COALITION OF COMMERCIAL AND INVESTMENT BANKS

Mr. ROSEN. Thank you, Mr. Chairman, and thank you for the continued leadership role that you have played in this issue over the years. The coalition believes that the most important attribute of the President's Working Group report is the consensus. In reaching any consensus obviously all individual views succumb to the weight where agreement meets. Undoubtedly, left to their own devices, each of these agencies would have produced a different report, but we have something better than four different views on this subject. We have one view. Whoever it was that first said that less is more I think had something like this in mind.

We should not really overlook the importance of this consensus because when we look back to the not too distant past, it was clear that we nearly compromised the vitality of our financial markets as a result of interagency jurisdictional competition. But we now for the first time have four agencies who are all rowing in the same direction.

Now I think the exchanges really have it right when they say that to some extent this is about drawing lines, and as we noted in our written testimony, the coalition believes that there is more that can be done in certain areas in establishing a regulatory framework within the Commodity Exchange Act for electronic trading systems that are not eligible for one of these exclusions in the area of hybrid instruments and legal certainty for non-financial derivatives. We also support modernization of the regulatory regime for exchanges and we also support the trading of single stock futures.

Even though we might have drawn the line somewhat differently had we had the luxury of drafting a report like the President's Working Group report, we think that it is nonetheless a very valuable starting point of departure for this legislative effort. Confirming the recommendations in the President's Working Group alone will be a very important step in providing legal certainty and ensuring financial innovation going forward in the U.S. financial markets, but we must maintain our perspective on what is most important in this process and what is less important in this process.

It is most important in this process to resolve the issues of legal uncertainty and barriers to innovation that hold back the United States financial markets and it is very important to provide a framework for the exchanges that allows them to compete on an appropriate basis both domestically and internationally. But there are other issues that are somewhat less important in this debate, issues that it would be nice to address, but it may be very difficult to address. For too long, accomplishing the legal certainty agenda has been held hostage to some of these other issues like the trading of single stock futures.

This is, I think, the fourth appearance I have made before this committee on these issues. I think we have been talking about these issues now for 10-years. We really need to resolve these issues. It is nice to see a general recognition that time is not our ally on them, and I want to confirm to the Committee that the coalition is committed to participating in a process that will result in successful legislation, but we must not allow our inability to achieve a perfect result to interfere with our ability to accomplish what can be accomplished.

I had some longer remarks prepared, but I candidly think that the debate and discussion that has occurred prior to this panel on issues of exemption versus exclusion, analogies to the securities law regulatory structure, comparability of economically similar products, has really raised the level of the debate on these issues and I look forward to an opportunity to addressing those issues.

[The prepared statement of Mr. Rosen can be found in the appendix on page 108.]

The CHAIRMAN. Well, thank you very much. Let me commence the questioning and I will call upon my colleague, Senator Fitzgerald. Let me address this to Chairman Brennan and Chairman Rappaport and Mr. Salzman. The Working Group report goes out of its way to state that futures exchanges are eligible to qualify for both the over-the-counter derivatives exclusion and the electronic trading system exclusion if they meet proper criteria. I am wondering has this been discussed at your exchange and what are your general conclusions with regard to that part of the report? Do you have a comment on that, Mr. Brennan?

Mr. BRENNAN. Yes, Senator. I think we have discussed this and I think to crystalize it, I think we are concerned about the fragmentation when you split off either pit versus electronic or retail versus institutional. We are very concerned about the fragmentation issue that has been discussed and maybe the ag versus the financial, you know, the finite supply versus the infinite supply, and we are wrestling with that, but that is the framework which we have been discussing it.

The CHAIRMAN. Do you have any comment on that, Chairman Rappaport?

Mr. RAPPAPORT. Yes. I think we agree in that sense that we are very concerned about what seems to be an effort to create what some people have referred to as the two-tier market, the retail versus the institutional, and we wonder why a similar structure in the securities law could not be created for the commodities. I think one of the problems that we have all been struggling with, and I agree with Ed Rosen before, I think the debate here, I think, is somewhat elevated from some of the ones we have had in the past years, is that we continue to struggle with this Commodity Exchange Act, trying to make it work within this environment. That is a very difficult thing to do because the simple question is, as Senator Fitzgerald pointed out, why is it that I can buy one share of a tech stock that has daily volatility of 500-percent, not unlike and perhaps a lot more than a lot of the commodities that we trade, and I can trade that right next to Goldman Sachs and Morgan Stanley and the most sophisticated investors in the world and there is no issue with that. And it is one marketplace, price discovery, transparency, everybody knows where it is, and I cannot do that with bond futures or I cannot do that with crude oil or gold, real global commodities? I think that is a very simple question that needs to be answered, and if it is, I think that will drive us to the solution. So in response to the simple question, we are very concerned about the fragmentation of the retail versus the institutional market.

The CHAIRMAN. Mr. Salzman.

Mr. SALZMAN. In addition to that fragmentation, I think we are also concerned about the notion of whether you need a disinter mediated market or an intermediated market and why should that make a difference. We have customers out there entering orders through the internet, but they do not go directly to our market. They first stop at an FCM's computer, if you could call it stopping, to have a credit check performed in a tenth of a second or even less, and then they come into our market. It seems to us that there is no good reason why that sort of a market ought to be treated differently than one where the customer comes in directly and his own credit is checked.

We actually think that there are very good reasons why intermediaries should exist in these markets, why they are the ones best suited to actually give customers information and to deal with customer credit, why it makes the market easier, more efficient to operate and why it makes clearinghouses work better. Until we fully understand why we would distinguish between those two markets, it does not seem to us we should be forced into the paradigm adopted by the Working Group in order to get the exemption or exclusion even. It just does not—we have not seen the reason behind it.

The CHAIRMAN. Mr. Grove and Mr. Rosen, I ask these questions of you. How important is clearing to the over-the-counter community? Most of the users of the over-the-counter derivatives market are large institutions that perhaps do not need clearing, may actually perceive clearing as an added expense. If OTC derivatives were allowed to clear outside the CEA, would there be a demand for those services?

Mr. GROVE. Clearing is an option that would be desirable for us to have but not necessarily one that dealers would take advantage of, at least not initially. There are other mechanisms that exist now, such as bilateral netting, and increasing the use of collateral, that serve some of the same purposes. But to prevent clearing for reasons that are not compelling, in our view, would be a mistake, and to the extent that clearing mechanisms evolve, we would certainly like the option to be able to take advantage of those mechanisms going forward.

The CHAIRMAN. Do you have a further comment on that, Mr. Rosen?

Mr. ROSEN. No. I would just note that there are different forms of clearing and there are different needs in different industry sectors. So, that informs the appetite for clearing, but I think it is clearly something which ought to be there because it does provide a benefit to the market and there ought to be a framework for it if it is going to exist.

The CHAIRMAN. Senator Fitzgerald.

Senator FITZGERALD. Thank you, Mr. Chairman. Mr. Grove, Do you believe that futures between sophisticated parties on non-agricultural or non-commodities, say on financial futures, between sophisticated parties on futures exchanges should be exempt from the CEA? Would you support legislation to exempt them from the CEA?

Mr. GROVE. Well, Senator, I support exclusion from the CEA of OTC derivatives products that, as the Working Group report concludes, are not susceptible to manipulation, do not serve a price discovery mechanism and do not involve retail investors.

With respect to the issue of competition, which is raised in Chairman Lugar's initial question to my colleagues from the exchanges and which I think follows on what from in the direction that you are going, the OTC derivatives market is one of the most competitive segments of the financial markets. There are no barriers to entry other than the competence of the dealers, the competence of their staffs, their reputation and their credit standing. My end user members would welcome even more competition, including from the exchanges, and our dealer members at this point face significant competition. It would not matter to them. We certainly welcome greater competition for financial derivatives.

Senator FITZGERALD. So you could support legislation that would exempt exchange-trades futures transactions involving an underlying financial instrument, as opposed to a commodity that could be manipulated or susceptible to manipulation? Could you support legislation to exempt them from the CEA?

Mr. GROVE. I would support legislation that would exempt those types of financial OTC derivatives products.

Senator FITZGERALD. You are saying OTC products. Futures by definition are not OTC products. They are traded on a futures exchange. I am talking about an exchange-trade financial futures contract, an interest rate futures contract, where the trading is between institutional parties.

Mr. GROVE. Senator, if Congress is of the view that those products can be appropriately deregulated, I would not oppose that legislation.

Senator FITZGERALD. OK.

Mr. ROSEN. Senator, may I chime in here?

Senator FITZGERALD. Sure.

Mr. ROSEN. Because I think you are asking an excellent question, and candidly I think if you strip away all of the different perspectives that people bring to the President's Working Group report, it is a wonderful catalyst for this debate because what it is really trying to do is strip away the labels, on exchange, off exchange, swap, future, and for the first time it is trying to say let us look at what is happening. Let us calibrate the level of regulation to the policy concerns that are raised. So when you say trading on an exchange, one wonders what do you mean by that? But I think the question is fair whether it is in an exchange environment or a non-exchange environment, if the nature of the participants, the way they interact with each other, the nature of the risks presented by the trading and the contract are identical to what they would be in an OTC context, there is not a legitimate basis for regulating them.

And candidly, I think this also answers the exemption versus exclusion question because if you believe that the basis for this treatment, whether you call it exemption or exclusion, is because you have analyzed the products and concluded that they do not raise policy issues of the type that this statutory framework was designed to address, then the question is what are you leaving for somebody to exercise their exemptive authority to do? There is no congressional directive or guidance for the execution or implementation of that administrative authority and you have sort of a free-floating you can step into any crisis authority or you have a meaningless authority, and that is why the truth of the matter is that Congress cannot escape the need if a situation arose that raised a different set of concerns than are currently addressed under the Commodity Exchange Act to establish the framework for addressing it. I think as a practical matter, though, there are other considerations that it is important to focus on.

These markets are populated mostly by regulated entities or affiliates of regulated entities who live in a regulated culture of shared risk management and direct and indirect oversight. If you look back at the LTCM event, what was of concern was not that LTCM got a leverage and blew itself up. I mean who really cares? What people really care about is what is the spillover effect to the people in the marketplace and the financial community who might be indirectly affected by that?

If you look at that landscape, the parties that were dealing with LTCM were regulated. They were comprehensively supervised. But we have all learned very important lessons from LTCM which will contribute to preventing a reoccurrence from that and I do not think we can escape responsibility for understanding that these are markets that are maturing and there are some things that regulators can do in addressing these problems and there are some things that they cannot do.

Senator FITZGERALD. I noted, Mr. Grove, in your testimony you said that the ISDA has developed master documentation templates for swaps transactions that are today used in the United States and around the world by the vast majority of swaps participants for their transactions. That sounds to me like these are pretty standard contracts and that they are fungible. And yet historically, the justification for disparate regulatory treatment between OTC swaps and futures traded on an exchange has been, well, the futures, they are fungible, they are the same contract, but right in your testimony you seem to indicate that really they are just a word processed document and you are changing the names of parties and maybe the terms of whatever interest rate flow is being swapped; is that correct?

Mr. GROVE. Most of my colleagues on the legal side wish it were so, but I can assure you, Senator, that those agreements are heavily negotiated, sometimes for periods of many months and on into years. The important point, though, is that those templates, those master agreements, allow market participants to engage in, an infinite variety of OTC derivatives transactions. The economic terms of each transaction differ from trade to trade and that is the important point.

Senator FITZGERALD. So if you had contracts where the economic terms did not differ, say you are right now selling five banks interest rate swaps and they all want the same deal right now, then there might be justification for some regulation there because they would all be the same agreement? Theoretically, at least 5 banks could get the same swap agreement if they are coming in the same interest rate environment trying to hedge their current interest rate exposure?

Mr. GROVE. The volumes are such that it could occur that there would be identical transactions, but, it would be coincidental that there would be identical transactions, and if there were five identical transactions, there would be tens of thousands of transactions executed during that period of time that would be very different.

Senator FITZGERALD. So you would have no objection to putting into this exclusion that would apply to interest rate swaps, for example, that the exclusion would not apply if the contracts were identical, that some prohibitions so no two contracts be the same?

Mr. GROVE. Senator, that would not be workable because as a party to a transaction, I would not know what other transactions existed in the market. So it might be that two other banks or two other parties were engaging in that same transaction or a transaction with the same exact notional amount, the same exact interest rate and the same exact maturity, but I would not know that and it would be pure coincidence. It would be an unworkable——

Senator FITZGERALD. But the underlying legal documentation is pretty standardized; isn't it? We are really just talking about you attach immense importance to changing these little things like exactly how much is the notional amount and exactly when the contract is going to end. I mean that is where you hang all this importance on those little tiny differences?

Mr. GROVE. That is because the contract deals with issues like bankruptcy; what happens if a counterparts goes into bankruptcy? Credit-type terms are dealt with in the master agreement. The economic terms vary from trade to trade and, not the credit terms are not important, they are, But economic terms are quite important as well.

Senator FITZGERALD. I notice that you also request that there be some provision in the bankruptcy code and I take it to mean that you would like something in the bankruptcy code that a defaulted party under one of these swap transactions could not discharge that debt in bankruptcy? Is that what you are looking for?

Mr. GROVE. No, what we are looking for—in fact, this provision is included in the bankruptcy bill that has just recently passed the Senate for which we are very appreciative. We are looking for provisions that further solidify the law as it now exists in the United States which recognizes that swap transactions between two counter parties in a bankruptcy situation could be netted down to a single amount. This has the effect of reducing systemic risk. What we are looking to do is bring more transactions within that umbrella so that again if a bankruptcy does occur, more transactions can be netted down to a single number, thereby reducing the exposure of the financial system as a whole to the bankruptcy of that one entity.

Senator FITZGERALD. Throughout your testimony or in your paper that you have submitted, you talk about the importance of legal certainty and you say that there are three things you need: clarity concerning how swap transactions will be treated under U.S. law, certainty that they will be legally enforceable, and certainty that key provisions in swap transactions will be enforceable even in the case of bankruptcy of one of those parties. So you keep focusing on legal certainty, but is there not one thing, one other thing that you want that you have not mentioned? You do not just want legal certainty. We could give you legal certainty within the ambit of CEA in their regulation. You might not like it, but you would have legal certainty. You want complete exemption from the CEA in addition to legal certainty; is that correct?

Mr. GROVE. We support the Working Group's recommendations that an exclusion is the best way to achieve the objectives that the Working Group has set out in its report. We think that as Secretary Summers said earlier and as Chairman Greenspan said earlier, that bright line distinctions, absolute certainty, is important in the financial markets. We need to know in good times and in bad that contracts will be enforced, that the agreements that we enter into in good faith, whether we are end users or whether we are dealers, that those agreements will be enforced in accordance with their terms.

We are skilled, particularly on the dealing side, skilled at managing market risk and we are skilled at managing credit risk. That is our business. But legal risk is not a risk that we can manage in any way. And, legal uncertainty, particularly in a time of market volatility and market crisis, can undermine the confidence of the public in the financial system of the United States and lead to systemic implications.

Senator FITZGERALD. Let me—I understand your position on that—I want to pursue this area a little bit more on the exemption. The report recommends that only principal trades be eligible for exclusions from the CEA and frequently refers to markets where quote "principals are trading for their own account." Is it always easy to tell when somebody is a quote "principal trading for their own account"? If a firm acts as a buyer to customer one and turns around and acts as a seller to customer two, has it really acted as a principal or as an intermediary? What would be your position on such transactions?

Mr. GROVE. Senator, when counter parties transact, they know who they are transacting with. They cannot always know what their counter party is then doing with the position and what other trading that counter party is engaging in. And I think to suggest that it should be the obligation of Party A to know what Party B will do next or what other transactions Party B is entering into would be inappropriate.

However, should there be a transaction between Party B and Party C that raises different regulatory implications, then perhaps a different regulatory regime should apply. In other words, if we have an institutional transaction here and a retail transaction there, I take your point that perhaps a different regulatory regime ought to apply, but it is not the obligation of Party A to know what Party B does.

Senator FITZGERALD. But put the Working Group's report into law, I mean it looks like there would really be nobody policing that to make sure it is really principals trading between principals. That one of those apparent principals is really not just an intermediary.

Mr. GROVE. Take the example of retail foreign exchange, Senator. In that case, I assume that if those recommendations of the Working Group report were enacted into law that there would be some mechanism in place for policing whether those transactions were being done in accordance with the law. I would believe that,

that would be part of legislation or regulatory enactment following legislation.

Senator FITZGERALD. Because then it would be governed by the CEA?

Mr. GROVE. Because then you are into a different part of the statute and it would be governed perhaps by CEA.

Senator FITZGERALD. But in this case, leaving aside foreign currency and so we are out of the Treasury Amendment, and you have an interest rate swap, and you have a trade between what you think are two principals. One of them turns around and sells to a retail person. Who would come in to the regulate that?

Mr. ROSEN. Senator, if an exemption of an exclusion were crafted that depended upon transactions actually being conducted as principal transactions and they were not, the CFTC has the authority to investigate that the act is, in fact, being complied with or not. And, if those are, in fact, not principal trades, the CFTC can take action. The focus on the principal character of the relationship is extremely important because there is relatively little opportunity for abuse when you and I do not have a transaction with each other until we have looked each other in the eye and agreed on the terms as opposed to a situation where I ask you to represent me in a market that is opaque to me and you come back and tell me what you have done at the end of the day after the order has been passed through three other hands.

If you look at the history of CFTC reparations and enforcement and abuses, I am sure the vast majority of those problems have resided in situations where agents were representing parties and not dealing directly with them as principal.

Senator FITZGERALD. Now this vast OTC unregulated environment that exists now and that you anticipate would continue in the future under new legislation, I mean the exclusion would have the effect of denying retail customers access to that market, which is very liquid. What do you think about that? I mean what is the policy behind setting up a regime that keeps retail customers away from that market and having no access to those available pools of liquidity?

Mr. GROVE. Senator, this is a market, the OTC derivatives market, that is most appropriate for institutional participants. It does involve in most cases two-way credit exposure so that if you were a bank and I am a retail person, you would not enter into an interest rate swap with me because of my credit standing. You want to enter into these types of transactions with entities that have a fair degree of credit worthiness because at any given point in time the value of the obligations could run either way.

So in that sense, it is not a market that is likely to expand into the retail arena. But I appreciate your point about bifurcation between retail and institutional markets. Let me say, though, that to deny the benefits of this market to American businesses, to American financial institutions, to American governmental entities, and to prevent them from hedging their financial market and commodity market exposures in the most efficient and most effective way possible simply to put them on a parity with individuals like me would be an inappropriate costly step. It would deny the benefits——

Senator FITZGERALD. Now you know how the exchanges feel.

Mr. GROVE. It would deny the benefits of these transactions and that would clearly have an impact on the profitability of those companies, and those financial institutions, and on the ability of governments to deliver services as efficiently, and would obviously have an impact on the U.S. economy.

Senator FITZGERALD. Would you guys like to comment, Chairman Brennan or Chairman Rappaport, Mr. Salzman, from the exchange perspective on the bifurcation of the market? Would you like to elaborate on that a little bit more? Would you be opposed if the Chicago Board of Trade, say the new legislation would allow you to set up an exchange where only institutional parties could trade financial derivatives and there would be no application of the CEA? Would you be opposed to that?

Mr. BRENNAN. Separating out the retail from the institutional?

Senator FITZGERALD. Yes.

Mr. BRENNAN. I think we would, yes, because what drives liquidity in these markets is not only the big players, but it is all the players I do not think that we want to get into a situation where we exclude a certain segment of the players; everybody should have access to that liquidity. I would be troubled by the bifurcation because some of these markets are very deep and liquid and some are not. It depends on the product. It also depends on volatile times and sometimes it is not always that transparent to the marketplace who is providing that liquidity.

Senator FITZGERALD. I mean if we were to bifurcate this, I mean you could end up just with a place for trading for institutional people or ways for institutional parties to trade and really no market for the retail investors potentially. I mean does anybody on the panel care to comment on that? Yes.

Mr. RAPPAPORT. Can I make an analogy that is related to the securities analogy that I made before? I mean how do you think the securities industry would feel if the rules were that you could not really trade stocks unless you traded above 100,000-shares and anybody who traded less than 100,000-shares had to go through some sophisticated entity that had good credit worthiness to trade that? You can imagine that the price, that if you were trading 1,000-shares instead of 100,000 is not going to be as good and it is not going to be as competitive. I think that is the situation that we are talking about. What would happen in that situation is exactly the scenario that you laid out before is that the parties that did not have the credit worthiness, parties like myself and Mr. Grove, would have to go a credit worthy party and say buy this for me.

If the marketplace were transparent enough that the price would be readily available that we could all look at it and say, okay, buy it for me at that price, then they would do it and then they would do their transaction with me. How that lesser transaction would be regulated would probably be under some more onerous level of regulation because the philosophical approach to the market would be the retail customer has to be protected, whereas the other market would be in this relatively unregulated environment, which by the way we support. There are a lot of things that we disagree with here, but it is mostly because we are at this and have historically been at this regulatory disadvantage and while we understand why the OTC marketplace is seeking this regulatory certainty and some other advantages, clearing and some other, which I have a lot of questions on clearing that I would like to address, you know, here or at some other time, we understand why they are seeking that. It is just the fact that we have never been able to get there ourselves to get that regulatory parity that sort of brings us here today.

Mr. SALZMAN. Could I just explain? The Chicago Mercantile Exchange now operates electronic markets for its stock index products, its S&P and its Nasdaq. They are the most tremendously successful markets in terms of the time to maturity that we have ever seen. And the great thing about these markets is that a public customer with an internet access can get the price he sees in the market by pushing a button. He can get to the front of the line by pushing a button sooner than an institutional customer. He is exactly on a par with that customer. He sees the market equally. He has equal access to all the prices in the market.

The only difference between him and a futures commission merchant is, as I said, his order flows through somebody else's computer to have its credit check before it gets to our market. I think we would be very reluctant to all of a sudden say to the retail customer you cannot have access to the same market in which the institutional people are playing because you have to have your credit checked by somebody else's computer or because you do not have $10 million in net assets. So long as the person has had appropriate risk disclosure and so long as the futures commission merchant is setting a credit limit on the positions he can take, which they do for their own protection, we do not want to see these markets fractionated. We just do not want to see them divided up. We have nothing against what they want, I assure you.

Senator FITZGERALD. That would be much different than what we do in the area of regular securities trading where everybody is treated pretty much the same.

Mr. ROSEN. All of these references to the securities markets remind me of the admonition "Be careful what you wish for." I think that if the principle of securities law regulation were applied to futures, people would be very surprised with the results. Again I go back to the President's Working Group report, if you analyze what the purpose of this statutory framework is, it is a different, very, very different framework than the securities laws.

Securities laws are protective of the capital formation process. Commodities do not give rise to information disparities in the same way that the securities markets do and the integrity of the capital formation process and the securities markets depends upon regulation of the informational disparities in the marketplace whoever you are. If you go back to the history of the Commodity Exchange Act——

Senator FITZGERALD. Well, basically inside information is legal in trading commodities. It is legal in trading real estate. They may know the state is going to put a new interstate right next to where you want to put this office building. It is legal there, but we have said it is not legal in securities.

Mr. ROSEN. Right. But because the essence of the use of futures as hedging devices is trading on inside information. The very purpose of the market and the regulatory regime was to ensure that the prices that were being discovered on the boards of trade were accurately reflected market conditions because businesses were relying on them and the reason speculation was permitted in those markets at all was because it contributed to the liquidity that make those markets more vibrant, but there is a very, very great disparity between basically commercial risk shifting transactions and investment opportunities.

I think we have to also bear in mind that the President's Working Group report does not require you to bifurcate the model. It allows you to build your business model. It allows you to build your business model and says when you build your model, if you introduce factors that give rise to a legitimate public interest and regulation, then you will live with the regulatory consequences. So nobody has to drive toward that, and if the regulatory regime for the exchange markets is rational and appropriately calibrated to the risks and not overly burdensome, there should not be an inducement for someone to shed their traditional market participants in order to survive.

I think that is the goal to ultimately be hoped for is that at the end, each level of activity is appropriately regulated because as you know, if you look at on the international dimension, you cannot get exactly the same trade terms with every country or the same economic conditions, and if your predicate was to make all of this playing field level, you would never have anything to do. So we have to get focused on what the right issues are which is to make sure that legitimate activity can be conducted with an appropriate level of regulation that does not hold the participants back and harm this country's economy.

Senator FITZGERALD. I think I have gone on long enough, Chairman Lugar. So I yield to you.

The CHAIRMAN. Well, you have, I think, conducted a really very important dialogue that has occurred I suppose behind the scenes. It has occurred now in front of the scenes. Let me just say, and I do not mean to diminish the importance of anything that has been said, but some who are in the room, many of you who are participating in this hearing, will recall that about 4-years ago we attempted much more modest type of reforms principally with the CFTC. We were not as global as the President's Working Group, which arose largely because of the over-the-counter difficulties that our country and the world was facing. Of course, that was 4-years ago. Chairman Greenspan corrected me that the Mexican was 5-years ago—time goes by rapidly. One reason we did not progress maybe as we should have was that, first of all, we did not have Senator Fitzgerald who has an intense interest in the whole subject.

[Laughter.]

There was at that time, and there were other disputes, but the board of trade and the Merc even in Chicago had very diverse views on many of the issues, in fact, so diverse and so embattled that most of the members of our committee were simply exhausted by the process. They said finally our constituents are hog farmers and people that are in cotton and so forth, and this is all very interesting, but by and large—this is not withstanding, Senator Fitzgerald, who is deeply interested in this—simply lost interest. They moved on to a different agenda, but say life moves on.

Now lots of things have happened in the world subsequently, and one of the four points of the Working Group, which is not necessarily definitive with regard to all the rest of them, is just simply the problem of all of our markets vis-a-vis the world. In other words, we could have a situation, I can envision, in which we are deeply concerned defensively about who does what business on which floor and in which way, but most if not all of it diminishes, and as a matter of fact, we are left dealing with a smaller and smaller pie which would be unfortunate.

Now, at this particular stage, each of you appreciate the gravity of the issues. Everything seems to be up for grabs again, and I understand that, and Senator Fitzgerald's questions have offered an opportunity for advocacy and defensiveness and what have you, as the case may be. What I hope at the end of the day might be possible, and we will hear from Chairman Rainer soon, in terms of his recommendations, but if he has a substantial proposal that brings significant regulatory relief to everybody that deals with CFTC, conceivably this will be attractive.

Now other parts of the bill may be unattractive. Each of you finally have to decide at the end of the day what the pluses and minuses are of this business because having heard this all today and having heard it other times, I cannot find at least a path that you weave through all of the mine fields here that will leave everybody excited about the product.

But I do think it is important to have one and so I in a general way will say that I am determined to proceed to try to get one and so we really appreciate the testimony you have given today as well as very important answers on details and very specific, very technical questions. Because whether the Senate as a whole is interested in this question or not, at least the two of us are, and there are other members, and ultimately that will probably guide whether we have a bill or not.

Now if we do not have a bill, many people would say time is not in our favor. Maybe some of you would say, well, that is not true of my situation, but in a way I think it probably is. Leaving aside the jurisdiction we are talking about today, it was my privilege to open up the New York Stock Exchange in December one day. After I did my duty, I went down on the floor and visited with traders and other people who are involved in that sort of thing and very quickly they were making an argument of why what they do there is unique and important as opposed to where else it could be done, namely maybe on the commodity exchanges with single stock trading, for example, why New York Stock Exchange can do this better than somebody else. I understand. I listened to their argument. Likewise, why that stock exchange as it is important.

Now at the same time, you know, you visit, as I did the same day, barely off the floor with people who already are envisioning plans for handling it in a very different way. Mr. Grasso and others understand that and they have been busy as all of you have in managing your situations. This is changing rapidly with major players who sort of pay the bread and butter of all of this and the upkeep and so forth, but suddenly have decided the way the world works some other way may be better. Maybe some other country. And, that is serious.

So I take that seriously and this is why we are in the urgent time frame of this and asking, subjecting you to all these questions. But I appreciate your coming. Senator, do you have another comment or question?

Senator FITZGERALD. I guess we were not supposed to talk about Shad–Johnson today. Was that the——

The CHAIRMAN. The thought was that we would take that up after we get a report from both the SEC and the CFTC who were asked by Senator Gramm and me and others to sort of come together jointly and they are supposed to do that I think by the 21st of February.

Senator FITZGERALD. Well, without discussing it here, could I ask Mr. Grove and Mr. Rosen to maybe give the Committee in writing what their views would be on the possibility of futures on individual stocks?

Mr. GROVE. Sure.

Mr. RAPPAPORT. Be happy to do that.

The CHAIRMAN. For that matter, any of you may offer thoughts about that. This is obviously——

Senator FITZGERALD. They like the idea.

The CHAIRMAN.—a very big issue.

Senator FITZGERALD. They do.

The CHAIRMAN. Yes. Clearly, Senator Fitzgerald points toward a demarcation point. I know Secretary Summers asked prior to the hearing the extent to which we would get into that and we did mention. I mentioned in the opening statement that this is an issue out there, but we are trying very hard once again to work on a parallel with the Banking Committee, the SEC and the CFTC in the spirit of this Working Group, see what we can find. We have had comments by Phil Johnson, one of the authors of the accord. My service in the Committee and in this particular area even goes back to visiting with Phil Johnson when he was working with John Shad on the agreement they came up with.

Those of you who participated in our round table last year, and Senator Fitzgerald was here, will recall some historians sort of recalling their thoughts about how permanent, how temporary, what the conditions were, but all of this is to be revisited soon.

Well, gentlemen, I thank you very much for giving us your time and we appreciate the attendance of all the audience that listened in today. Thank you very much.

Mr. GROVE. Thank you, Senator.

[Whereupon, at 12:12 p.m., the Committee was adjourned.]

APPENDIX

FEBRUARY 10, 2000

OPENING STATEMENT OF HON. RICHARD G. LUGAR

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

FEBRUARY 10, 2000

CEA RE-AUTHORIZATION

Today the Senate Agriculture Committee holds its first hearing of the year on the reauthorization of the Commodity Exchange Act. This hearing, with its distinguished list of witnesses, will discuss the unanimous findings of the President's Working Group regarding the proper treatment of the over-the-counter derivatives market.

In late 1998, House Agriculture Committee Chairman Bob Smith and I wrote Treasury Secretary Rubin requesting that the President's Working Group study and make recommendations to Congress regarding these instruments. Our request came on the heels of an economically turbulent period, which witnessed a Russian default of its debts, the devaluing of the ruble and the near-collapse of Long-Term Capital Management Hedge Fund. In addition, the CFTC was making overtures through its concept release on over-the-counter derivatives that it may seek to unilaterally regulate these instruments. In requesting this report, we sought to bring certainty to these markets and to build a broad consensus on the government's role, if any, in regulating them.

I have long stated that one of my goals for Commodity Exchange Act reauthorization is to provide legal and regulatory certainty to the over-the-counter market. With its recommendations on the legal certainty of swaps, the Treasury Amendment and electronic trading, I am confident that this unanimous report will provide Congress with the guidance it needs for achieving this important goal.

But the Working Group's recommendations cannot exist in a vacuum. Another important goal of reauthorization is providing regulatory relief for those entities that fall within the Commodity Exchange Act. The Working Group recognized that its recommendations regarding the over-the-counter market must be implemented simultaneously with the lessening of regulation for the futures exchanges. Along with other Members from the House and Senate Agriculture Committees, I have requested that the CFTC make its recommendations on regulatory relief by February 14th. I understand that Chairman Rainer will meet this deadline and intends to brief Members on this proposal shortly.

Addressing the Shad-Johnson Accord also is a priority. The President's Working Group agreed that the current prohibition on single stock futures can be repealed if issues regarding the integrity of the underlying securities market and regulatory disparities can be resolved. Senate Banking Committee Chairman Phil Gramm and I have written SEC Chairman Levitt and CFTC Chairman Rainer requesting that the Agencies study this issue and make recommendations by February 21st. Senator Gramm and I have pledged to work together throughout this process, including the possibility of holding joint hearings, to ensure that both over-the-counter and on-exchange instruments are appropriately and consistently treated under our laws. Although it would be premature today to discuss in detail the reform of the Shad-Johnson Accord without the benefit of the Agencies' input, I would emphasize that this issue remains a priority with the Committee.

This Committee is faced with the daunting task of drafting this complicated legislation in a year drastically shortened by a full Congressional calendar and a Presidential election. In my view, Congress has a three month period of time to pass this bill or resign itself to the fact that it will not get done until next year.

However, the ramifications of waiting are considerable. Given the fact that we will have a new Administration, a new Congress, and even possibly a new Chairman of this Committee, the present time appears to be the most opportune for Congress and the industry to achieve consensus on comprehensive reauthorization legislation, and I intend to actively promote its passage this year.

Turning towards today's discussion, our first witness this morning will be Treasury Secretary Laurence Summers, head of the President's Working Group, who will outline the Report's unanimous findings.

Our second distinguished panel will consist of the other members of the Working Group: Chairman Alan Greenspan of the Federal Reserve; Chairman Bill Rainer of the CFTC; and Ms. Annette Nazareth, Director of Market Regulation at the SEC.

Our final panel contains members from the private sector, including representatives from the futures exchanges and the over-the-counter derivatives community.

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Statement for Senator Charles Grassley for the Hearing on the President's Working Group on OTC Derivatives

Mr. Chairman, I would like to thank you for holding this hearing. As you and the rest of my colleagues in attendence this morning already understand, finding a mutually agreeable position on many of the issues within the context of reauthorizing the Commodity Exchange Act will be a challenging process.

For that reason I would also like to thank the panelists for sharing their time with us to discuss OTC derivatives and specifically what the President's Working Group was able to conclude last November.

As we all know, the President's Working Group established a framework for determining which instruments should, in their *unanimous* opinion, be excluded from the Commodity Exchange Act.

I also look forward to hearing from the representatives of our future exchanges and their interpretation of the boundaries established by the Working Group.

Mr. Chairman, due to your interest and intiative we have a chance to advance the debate surrounding this complex issue. Thank you for this opportunity.

EMBARGOED UNITL 9:00 A.M. EDT
Text as prepared for Delivery
February 10, 2000

TREASURY SECRETARY SUMMERS
SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

Mr. Chairman, Senator Harkin, Members of this Committee, thank you for giving me the opportunity to discuss the report of the President's Working Group on Financial Markets on *Over-the-Counter Derivatives Markets and the Commodity Exchange Act*. The issues covered in the report have been a focus of this Committee, and on behalf of the members of the Working Group, we thank you for the leadership you have demonstrated on these important issues.

The over-the-counter derivatives market is an important component of the American capital markets and a powerful symbol of the kind of innovation and technology that has made the American financial system as strong as it is today. Yet the continued development of this market will depend a great deal on the development of a clear and effective regulatory environment.

The report of the President's Working Group contains the unanimous recommendations of a group that included, among others, the Chairmen of the Federal Reserve, the Commodity Futures Trading Commission and the Securities and Exchange Commission. It recommends the enactment of legislation to reform the legal framework affecting the OTC derivatives market. Taken together, these changes would provide legal certainty, contribute to the reduction of systemic risk, protect retail customers, stimulate the competitiveness of America's financial markets, and thereby help to create jobs and lower costs for American consumers and businesses.

Let me divide my remarks into three parts:

- First, the growing importance of OTC derivatives in the US economy.
- Second the objectives that guided Members of the Working Group when deciding on its recommendations and the importance of enacting those recommendations within the shortest reasonable time frame.
- Third, the six recommendations that the Working Group has produced.

I. The Role of OTC Derivatives in the US Economy.

Mr. Chairman, the financial sector is the central nervous system of the American economy. As our economy and our financial markets have evolved over the past two decades, so too have the needs of the financial sector. Most notably, in an era of globalization, volatility of interest rates, increased securitization and the growth of the bond markets relative to the traditional loan markets, businesses and financial institutions have needed more and better tools for managing risk.

In that sense, the over-the-counter derivatives market has grown directly in response to the needs of the private sector. An OTC derivative is an instrument that allows a party seeking to reduce its risk exposure to transfer that exposure to a counterparty that wants and may be in a better position to assume the risk. This is a potent development that has significantly enhanced the ability of businesses to manage their risk profiles, to compete more effectively in the global marketplace, and to deliver more efficiently and at lower cost a wide range of services and products to the American consumer.

Because of these rising demands, the notional value of global OTC derivatives has risen more than five-fold over the past decade, to more than $80 trillion according to estimates produced by the Bank for International Settlements.

Operating within a proper and appropriate framework of legal certainty, the benefits to the American economy of OTC derivatives would continue to grow. For example:

- By helping businesses and financial institutions to hedge their risks more efficiently, OTC derivatives enable them to pass on the benefits of lower product costs to American consumers and businesses.

- By allowing for the transfer of unwanted risk, OTC derivatives promote the more efficient allocation of capital across the economy, further increasing American productivity.

- By providing better pricing information, OTC derivatives can help promote greater efficiency and liquidity of the underlying cash markets that feeds into a stronger economy for all Americans.

- And, by enabling more sophisticated management of assets, including mortgages, consumer loans and corporate debt, OTC derivatives can help lower mortgage payments, insurance premiums, and other financing costs for American consumers and businesses.

Thus, OTC derivatives have the potential to bring important benefits to our economy. The goal of the recommendations of the President's Working Group is to ensure that these benefits can be realized. At the same time, we need to recall that the emergence of the OTC derivatives market has come during an era of unprecedented economic strength and prosperity.

It is to be expected that in times of distress some participants in this market, as in other financial markets, will be adversely affected. What needs to be protected are not individual institutions, but the system as a whole. The challenge is to strike the appropriate balance between the creation of a regulatory regime of legal certainty that allows the economy to realize the benefits of OTC derivatives while still providing appropriate protection for retail customers and the system. In our judgement, the best protection against systemic risk is market discipline.

Now let me turn to the more specific goals of the Working Group in producing the report.

II. Objectives of the Working Group's Report

Mr. Chairman, the members the President's Working Group believe that a strengthened OTC derivatives market can contribute to the greater efficiency of the US economy. They further believe that a failure to act in this area would risk a situation in which the existing legal framework for our financial markets would seriously lag the development of the markets themselves.

In the absence of an updated legal and regulatory environment, needless systemic risk might jeopardize the broader vitality of the American capital markets; innovation might be stifled by the absence of legal certainty; and American consumers might be deprived of the benefits that a more appropriate legal framework would deliver. We also risk an erosion of the competitiveness of American financial markets, with an increasing amount of business moving offshore to jurisdictions where the regulatory framework has kept up with the pace of change.

It was with these priorities in mind, Mr. Chairman, that last year you requested the Working Group to study the OTC derivatives market and recommend what changes were required. The Working Group worked on the assumption that legislative action would be required within a timeframe appropriate to the growing importance of the OTC derivatives market – and taking into account this market's potential contribution to the efficient functioning of the American financial sector and to that of the economy as a whole.

Accordingly, the Working Group sought to achieve four objectives:

- **To reduce systemic risk** in the OTC derivatives market by removing legal impediments to the development of clearing systems and ensuring that those systems are appropriately regulated.

- **To promote innovation** in the OTC derivatives market by providing legal certainty for OTC derivatives and electronic trading systems. This would strengthen the overall legal framework governing the OTC derivatives market that, in turn, would stimulate greater competition, transparency, liquidity, and efficiency and deliver stronger benefits to US consumers and businesses.

- **To protect retail customers** by ensuring that appropriate regulations are in place to deter unfair practices in all markets in which they participate and by closing existing legal loopholes that allow unregulated entities to pursue such unfair practices.

- **To maintain US competitiveness** by providing a modernized framework that will lead those engaged in the financial services industry to continue the operations of their businesses in the United States, and thereby assuring the continued leadership of American capital markets.

III. The Recommendations of the President's Working Group.

Before outlining the Working Group's recommendations in greater detail, it bears emphasis that the Working Group did not reach its conclusions lightly. In view of the technical nature and history of many of the issues considered, the unanimous nature of our recommendations is very significant. It is our firm belief that the situation calls for legislation at the soonest appropriate opportunity. I will now turn to the recommendations.

1. Create an exclusion from the CEA for most swaps agreements.

The Working Group is recommending that an exclusion for certain swaps between eligible counterparties be codified by Congress in the Commodities Exchange Act. This exclusion would be similar to the CFTC's 1993 rule exempting swaps. It would not, however, extend to agreements involving non-financial commodities with finite supplies that could potentially be subject to manipulation, such as agricultural commodities. The CFTC would retain exemptive authority for these types of swaps including swaps related to agricultural commodities. The exclusion would cover equity swaps, a category of swaps where there is also some amount of legal uncertainty.

Mr. Chairman, this recommendation would provide legal certainty by excluding interest rate and equity swap agreements from the scope of the CEA, and remove doubts about the enforceability of these contracts in the courts. It is clear to the Working Group that this exclusion is the best approach to assure that the OTC derivatives market can develop within the kind of innovative and legally stable environment on which the continued competitiveness of our financial markets will depend. The exclusion would also contribute to the permanent clarification of the status of OTC derivatives that is essential for the integrity of the market.

The current legal uncertainty concerning whether swaps are subject to the CEA has its roots in the 1974 legislation that created the CFTC. That legislation significantly increased the scope of the CEA by broadening the definition of what constitutes a "commodity". As a result, most interest rates, for example, are now considered a "commodity" under the CEA and exchange-traded interest rate futures are thus regulated by the CFTC. We do not believe that off-exchange transactions that are tied to interest rates are themselves futures contracts and therefore should not be subject to CFTC regulation. To some market participants, however there has been uncertainty on this critical question.

The Working Group members perceive no compelling evidence of problems involving the swaps that we are recommending for exclusion that would warrant regulation under the CEA. Rather, we believe that an exclusion is appropriate because the participants in such transactions are generally capable of making informed investment decisions and do not require the additional protections of the CEA. We further believe that the legal certainty provided by statute will be more durable and reliable than that provided by regulations, which are more easily changed.

The CEA is designed primarily to address issues of fraud, manipulation, and price discovery. Sophisticated participants can protect themselves against fraud or can seek legal redress if they are defrauded. There is little evidence to suggest that markets for financial OTC derivatives are readily susceptible to manipulation. And, in the case of derivatives based on securities, existing securities laws would in any event be applicable to any attempts to manipulate security prices. In addition, financial OTC derivatives do not yet serve a primary price discovery function. And the activities of most OTC derivative dealers are already subject to direct or indirect federal oversight.

2. Create an Exclusion for Electronic Trading Systems.

This recommendation would create an exclusion from the CEA for electronic trading systems that limit participation to sophisticated parties trading for their own accounts. Again, the exclusion would not apply to trading systems involving non-financial commodities with a finite supply such as agricultural commodities.

By confining the exclusion to trading systems involving only qualified participants, this recommendation is designed to protect retail customers without unnecessarily obstructing innovation where regulation is not justified. Electronic trading systems promote transparency and efficiency and thus reduce the cost of trading interest rate and other types of swap contracts. In that sense the exclusion would strengthen the competitiveness of the American OTC derivatives market.

At the same time, while agreeing that an exclusion from the CEA is appropriate, the Working Group has undertaken to monitor the development of electronic trading systems for OTC derivatives going forward, with a view to evaluating whether limited regulation of these systems to enhance market transparency and price discovery should become appropriate at a later date.

3. Permit the Use of Appropriately Regulated Clearing Systems for OTC derivatives.

The third recommendation of the report would permit the creation of clearing systems for OTC derivatives while requiring that such systems be subject to appropriate regulation. This proposal is designed to reduce systemic risk by encouraging the creation of appropriately regulated clearing systems for OTC derivatives.

Well-designed clearinghouses can contribute significantly to reducing systemic risk: first, by diminishing the likelihood that the failure of a single market participant can have a disproportionate effect on the market as a whole; and second, by facilitating the offsetting and netting of contract obligations. A reduction in systemic risk would in turn enhance the stability of our financial system and increase its competitive edge. Nonetheless, in view of the concentration of risk within these entities, the Working Group believes that regulation of such clearing systems is appropriate.

4. Clarify the Original Intent of the Treasury Amendment

This recommendation would clarify the Treasury Amendment in two ways. First it would enable the CFTC to address the problems associated with foreign currency "bucket shops" by codifying the CFTC's authority to regulate such entities and to prosecute such entities when they attempt to defraud retail customers. This would support the CFTC's objective of regulating entities that allegedly defraud retail customers, thus strengthening protection for small investors.

Second, the recommendation would preserve CFTC authority over Treasury Amendment transactions on "organized exchanges" while excluding most other transactions in Treasury Amendment products from the scope of the CEA.

The Treasury Amendment was originally designed primarily to exclude trading of OTC derivatives tied to underlying government securities and foreign exchange from the regulatory scope of the CEA. The exclusion, as currently worded, applies to all such contracts unless the transaction involved the sale of futures on a "board of trade." But uncertainty persists about the precise meaning of what constitutes a "board of trade" and whether it could be interpreted to encompass entities such as investment and commercial banks.

As a result, the Working Group recommends that the term "board of trade" be replaced by the phrase "organized exchange" to provide legal certainty for OTC instruments excluded under the Treasury Amendment and that an appropriate statutory definition of "organized exchange" is provided.

5 & 6. Clarify the Exempt Status of Hybrid Instruments.

The final two recommendations are highly technical in nature and designed to enhance legal certainty by clarifying that hybrid instruments that reference securities can be exempted from the CEA. The recommendations also resolve potential jurisdictional disputes between the CFTC and other regulators with respect to such instruments by limiting the exclusive jurisdiction clause of the CEA.

IV. Conclusion.

Mr. Chairman, the President's Working Group has presented the Congress with a set of unanimous recommendations pertaining to the growing and increasingly important market for OTC derivatives in the United States. We believe that these recommendations, taken together, would reduce systemic risk, promote innovation, competition, efficiency and transparency in our financial markets; would protect retail customers, and would maintain American leadership in OTC derivatives markets.

In this context, we believe that legislation is necessary. We suggest a paradigm for that legislation that recognizes that with the appropriate legal framework, the OTC derivatives market can make a valuable contribution to the efficient functioning of the American capital markets, with benefits for businesses and consumers. Under the existing regulatory framework, as the report makes clear, there is a risk that these benefits will not be realized.

The Working Group's report focuses on OTC derivatives. There are also important issues of regulatory relief on exchange-traded derivatives. The Working Group supports the CFTC's ongoing efforts to explore regulatory relief in this area. I look forward to working with them and other members of the Working Group to assure that our markets remain the most competitive and innovative in the world, while assuring the integrity of these markets is protected for all participants. Thank you. I would now welcome any questions that you may have.

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For release on delivery
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Testimony by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Agriculture, Nutrition and Forestry

United States Senate

February 10, 2000

I am pleased to be here today to underscore the importance of this committee's efforts to modernize the Commodity Exchange Act (CEA) and to express my support for the recommendations for amending the act that were contained in the report by the President's Working Group on Financial Markets entitled *Over-the-Counter Derivatives Markets and the Commodity Exchange Act.*

The Need for Legislation

Over-the-counter (OTC) derivatives have come to play an exceptionally important role in our financial system and in our economy. These instruments allow users to unbundle risks and allocate them to the investors most willing and able to assume them. A growing number of financial and nonfinancial institutions have embraced derivatives as an integral part of their risk capital allocation and profit maximization. In particular, the profitability of derivative products has been a major factor in the significant gain in the finance industry's share of American corporate output during the past decade--a reflection of their value to nonfinancial industry. Indeed, this value added from derivatives itself derives from their ability to enhance the process of wealth creation throughout our economy.

In light of the importance of OTC derivatives, it is essential that we address the legal uncertainties created by the possibility that courts could contrue OTC derivatives to be futures contracts subject to the CEA. The legal uncertainties create risks to counterparties in OTC contracts and, indeed, to our financial system that simply are unacceptable. They have also impeded initiatives to centralize the trading and clearing of OTC contracts, developments that have the potential to increase efficiency and reduce risks in OTC transactions. As I shall discuss more fully later in my remarks, rapid changes in communications technology portend that time is running out for us to modernize our regulation of financial markets before we lose them and the associated profits and employment opportunities to foreign jurisdictions that impose no such impediments.

To be sure, the Congress and the Commodity Futures Trading Commission (CFTC) have taken steps to address these concerns about the CEA. The Futures Trading Practices Act of 1992 gave the CFTC authority to exempt OTC derivatives from most provisions of the act. In early 1993 the CFTC used that authority to create an exemption for OTC derivatives that reduced legal uncertainty for a wide range of transactions and counterparties. Unfortunately, some subsequent actions by the Commission called into question market participants' understanding of the terms of the 1993 exemption. Now, under the leadership of Chairman Rainer, the Commission is considering reaffirming and expanding the terms of the 1993 exemption. Nonetheless, even with such an important and constructive step by the Commission, legislation amending the CEA would remain critically important. The greatest legal uncertainty affecting existing OTC transactions is in the area of securities-based contracts, where the CFTC's exemptive authority is constrained. Furthermore, as events during the past few years have clearly demonstrated, regulatory exemptions, unlike statutory exclusions, carry the risk of amendment by future Commissions.

Principles of Regulation

Imposing government regulation on a market can impair its efficiency. Thus, when evaluating the need for government regulation, one must clearly identify the public policy objectives of the regulation. As the working group's report discusses, the primary public policy purposes of the CEA are to deter market manipulation and to protect investors against fraud and other unfair practices.

We must of course assess whether government regulation is necessary to achieve those objectives. The regulatory framework of the CEA was designed for the trading of grain futures by the general public, including retail investors. Because quantities of grain following a harvest are generally known and limited, it is possible, at least in principle, to manipulate the price of grain by cornering a market. Furthermore, grain futures prices are widely disseminated and widely used as the basis for pricing grain transactions off the futures exchanges. The fact that grain futures serve such a price-discovery function means that if attempts to corner a market result in price fluctuations, the effects would be felt widely by producers and consumers of grain.

OTC Derivatives

The President's working group has considered whether regulation of OTC derivatives is necessary to achieve these public policy objectives of the CEA. In the case of financial OTC derivatives transactions between professional counterparties, the working group has agreed that such regulation is unnecessary and that such transactions should be excluded from coverage of the act. Importantly, the recommended exclusion would extend to those securities-based derivatives that currently are subject to the greatest legal risk from potential application of the CEA.

The rationale for this position is straightforward. OTC transactions in financial derivatives are not susceptible to--that is, easily influenced by--manipulation. The vast majority of contracts are settled in cash, based on a rate or price determined in a separate highly liquid market with a very large or virtually unlimited deliverable supply. Furthermore, prices established in OTC transactions do not serve a price-discovery function. Thus, even if the price of an OTC contract were somehow manipulated, the adverse effects on the economy would be quite limited. With respect to fraud and other unfair practices, the professional counterparties that use OTC derivatives simply do not require the protections that CEA provides for retail investors. If professional counterparties are victimized, they can obtain redress under the laws applicable to contracts generally.

The working group also considered whether the introduction of centralized mechanisms for the trading and settling of what heretofore have been purely bilaterally negotiated and settled transactions would give rise to a need for additional regulation. In the case of electronic trading systems, the working group concluded that regulation under the CEA was unnecessary and that such systems should be excluded from the act, provided that the contracts are not based on nonfinancial commodities with finite supplies and that the participants are limited to sophisticated counterparties trading solely for their own accounts. Electronic trading of such contracts by such counterparties, it was reasoned, would be no more susceptible to problems of manipulation and fraud than purely bilateral transactions. It was suggested that some limited regulation of such systems might become necessary in the future if such trading systems came to serve a price-discovery function. But it was agreed that creation of a regulatory system for such systems in anticipation of problems was inappropriate. As I have already noted, the vast majority of OTC derivatives simply are not susceptible to manipulation. Thus, even if those contracts come to play a role in price discovery, regulation of the trading mechanism might still be unnecessary.

In the case of clearing systems for OTC derivatives, the working group concluded that government oversight is appropriate. Clearing tends to concentrate risks and responsibilities for risk management in a central party or clearinghouse. Consequently, the effectiveness of the clearinghouse's risk management is critical for the stability of the markets that it serves. Depending on the types of transactions cleared, such oversight might appropriately be conducted by the CFTC under the CEA. Alternatively, it might be conducted by the Securities and Exchange Commission, the Federal Reserve, the Office of the Comptroller of the Currency, or a foreign financial regulator that one of the U.S. regulators has determined satisfies appropriate standards. Provided such government oversight is in place, OTC transactions that would otherwise be excluded from the CEA should not fall within the ambit of the act because they are cleared. If market participants conclude that clearing would reduce counterparty risks in OTC transactions, concerns about legal risks associated with the potential application of the CEA should not stand in their way.

Traditional Exchanges

The working group's report does not make specific recommendations about the regulation of traditional exchange-traded futures markets that use open outcry trading or that allow trading by retail investors. Nevertheless, it calls for a review of the existing regulatory structures, particularly those applicable to financial futures, to ensure that they are appropriate in light of the objectives of the act. Consistent with the principles of regulation that I identified earlier, the report notes that exchange-traded futures should not be subject to regulations that are unnecessary to achieve the CEA's objectives. The report also concludes that the current prohibition on single-stock futures can be repealed if issues about the integrity of the underlying securities market and regulatory arbitrage are resolved.

I want to underscore how important it is for us to address these issues promptly. I cannot claim to speak with certainty as to how our complex and rapidly moving markets will evolve. But I see a real risk that, if we fail to rationalize our regulation of centralized trading mechanisms for financial instruments, these markets and the related profits and employment opportunities will be lost to foreign jurisdictions that maintain the confidence of global investors without imposing so many regulatory constraints.

My concerns on this score stem from the dramatic advances in information technology that we see all around us. In markets with significant economies of scale and scope, like those for standardized financial instruments, there is a tendency toward consolidation or even natural monopoly. Throughout much of our history this tendency has been restrained by an inability to communicate information sufficiently quickly, cheaply, and accurately. In recent years, however, this constraint is being essentially eliminated by advances in telecommunications. We have not yet seen clear evidence of a trend toward natural monopoly. But the diffusion of technology often traces an S-shaped curve, first diffusing slowly, but then rapidly picking up speed. Once we reach the steep segment of that S-curve, it may be too late to rationalize our regulatory structure.

Already the largest futures exchange in the world is no longer in the American heartland; instead, it is now in the heart of Europe. To be sure, no U.S. exchange has yet to lose a major contract to a foreign competitor. But it would be a serious mistake for us to wait for such unmistakable evidence of a loss of international competitiveness before acting. As our experience with the vast eurodollar markets demonstrates, once markets with scale and scope economies are lost, they are very difficult, if not impossible, to recapture.

William J. Rainer
Chairman
Commodity Futures Trading Commission

Testimony Before the Senate Agriculture Committee

Hearing on the Report by the President's Working Group on Financial Markets: "Over the Counter Derivatives Markets and the Commodity Exchange Act"

February 10, 2000

Thank you Chairman Lugar, Senator Harkin and members of the Committee. I appreciate the opportunity to come here and discuss the recommendations of the President's Working Group on Financial Markets regarding the Commodity Exchange Act and over-the-counter derivatives transactions.

U.S. financial markets generally are the envy of the world, whether we are speaking of futures, swaps or securities. Each of these sectors plays an important role in maintaining America's leadership in this area.

Our country's position in the OTC market is affected by uncertainty over the legal status of many derivatives transactions. This uncertainty turns on whether or not transactions could be invalidated under the CEA.

The members of the Working Group are unanimous in our assessment of America's national economic priorities for the over-the-counter derivatives markets. These goals have already been mentioned, namely:

- to promote technological innovation, competition, efficiency, liquidity and transparency; and
- to reduce systemic risk by encouraging the market to develop regulated clearing systems.

The ability to achieve these will be enhanced through greater legal certainty for the OTC market. Congressional action to exclude OTC financial derivatives from the Act would provide such certainty.

I can advocate this step because OTC derivatives transactions as we know them today do not present regulatory concerns within the scope of the Act. Also, excluding this activity will not diminish the CFTC's ability to carry out the statutory mission it is charged to fulfill.

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When the Commodity Exchange Act was written, Congress articulated the rationale for regulating futures transactions. First, the Act establishes the economic utility of futures trading, stating that futures prices "are generally quoted and disseminated throughout the United States and in foreign countries as a basis for determining prices to the producer and the consumer of commodities ...." In addition to their price discovery function, futures transactions are used by commercial handlers "as a means of hedging themselves against possible loss through fluctuations in price." *CEA Section 3.*

The second prong of Congress' rationale for regulation is that the "transactions and prices of commodities ... are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed ...." The risks of price distortion and manipulation are the factors "rendering regulation [of these markets] imperative ...." *CEA Section 3.* Congress thus identified the overarching public mission of the CFTC as that of preventing price manipulation and ensuring price transparency.

* * *

Like exchange-traded futures, OTC derivatives are risk-shifting instruments. The Working Group, however, has determined that, unlike futures, "prices established in OTC derivatives transactions do not serve a significant price discovery role." *PWG Report at 16.* The Working Group also has concluded that "[m]ost OTC derivatives are not susceptible to manipulation." *Id.*

According to the Bank for International Settlements, 72 percent of OTC derivatives are interest rate contracts and 26 percent are foreign exchange contracts.[1] A report issued recently by the Office of the Comptroller of the Currency stated that interest rate contracts constitute 79 percent of derivatives held in US commercial banks. Interest rate and currency products, which together comprise 98 percent of the OTC derivatives market, do not present the concerns Congress addressed in mandating the regulation of futures.

Moreover, OTC transactions are entered into and traded by sophisticated institutional traders, who are able to look out for themselves in these markets. Also, most dealers in the swaps market are either affiliated with broker-dealers or futures commission merchants that are regulated by the SEC or the CFTC, or are financial institutions that are subject to supervision by bank regulatory agencies. Therefore, the activities of most derivatives dealers already are subject to direct or indirect federal oversight. *PWG Report at 16.*

Because there is no manifest regulatory interest warranting CFTC oversight of OTC derivatives, I support the exclusion proposed by the Working Group.

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[1] Bank for International Settlements, Press Release, *The Global OTC Derivatives Market at End-December 1998* (June 2, 1999).

Congress and the CFTC have acted before to resolve legal uncertainty affecting OTC derivatives. In 1992, amid strong signals that swap market participants feared their contracts could be declared unenforceable, Congress responded decisively, instructing the CFTC not to regulate swaps entered into by sophisticated parties. Congress authorized the CFTC to provide exemptive relief for swaps without requiring the agency to make a threshold determination that particular exempted transactions fell within its jurisdiction.[2] The CFTC promptly issued a rule exempting swap agreements from all provisions of the Act except prohibitions against fraud and manipulation, provided the swaps meet certain conditions.

The CFTC's swaps exemption worked relatively well. Lately, however, evolution in the OTC derivatives market has rendered the exemption inadequate for some purposes.

The swaps exemptive rule does not apply to OTC contracts that are standardized, cleared, or executed under conditions that approximate those of an organized exchange. Technology, however, is dramatically changing the structure and nature of many aspects of the financial services industry. The rise of electronic, screen-based trading has blurred the line drawn in our swaps exemption between bilateral and multilateral trading. The growth in swap volume, and the acceptance of these contracts by a wider range of users, has led to their standardization. Public policy must meet these advances in the OTC market.

I also believe that the development of regulated clearing systems should be encouraged. Clearing systems can employ a variety of risk management tools, such as mutualizing risk and offsetting multiple obligations. Consequently, clearing systems help reduce systemic risk by lowering the possibility that the failure of a single market participant could disproportionately disrupt or impact the overall market.

Finally, the Commission's rule exempts bilateral swaps from all provisions of the CEA except those provisions prohibiting manipulation and fraud. The CFTC thought it prudent to retain its jurisdiction to act in the event the agency learned that participants were engaging in fraudulent or manipulative conduct and that transactions executed under the exemption were, in fact, futures.

The swaps exemption does not alter the CFTC's responsibility to take action against this misconduct. In a given set of circumstances, however, the agency's ability to act may be contingent upon proving that transactions are futures or options.[3] This is a critical point to remember: at no time has Congress or the CFTC made the definitive judgment that swap transactions are, in fact, subject to the CEA's jurisdiction. The combination of responsibility with no more than contingent authority, is simply bad

[2] *See* Conf. Rept. 102-978, Futures Trading Practices Act of 1992, at 81-82 (Oct. 10, 1992).

[3] The CEA authorizes the Commission to take enforcement action against "any person" suspected of attempting to manipulate "the market price of any commodity in interstate commerce," irrespective of whether the suspected misconduct occurs in the cash commodities markets or on-exchange. *CEA Section 6(c).*

public policy because as a practical matter, the CFTC cannot exercise its residual enforcement authority under the swaps exemption without exacerbating the existing legal uncertainty in this area.

* * *

Apart from legal certainty issues regarding OTC derivatives, the Working Group report contains recommendations aimed at improving the regulatory framework for other financial instruments. Some of these proposals have been addressed by other members of the Group. I would like to comment on the recommendation to alter the "Treasury Amendment" provision of the Act to give the CFTC explicit jurisdiction over unregulated entities that sell foreign exchange instruments to the public at large.

Abusive promoters have exploited regulatory gaps to sell foreign currency contracts to financially unsophisticated individuals, making exaggerated claims of profit opportunities and failing to disclose the risks of these inherently volatile instruments. Promoters often target senior citizens, recent arrivals in this country and other vulnerable segments of society.

Many of these enterprises simply pocket investor funds; others channel funds to currency markets, but typically do so without adequate segregation or disclosure. As fraudulent forex companies proliferated, the agency in 1998 issued a consumer advisory through the mass media warning the public about these schemes. Cases filed by the CFTC against illegal foreign currency operations during the 1990s have involved more than $250 million in customer funds.

Courts in which the CFTC has brought enforcement actions have reached varying decisions regarding our jurisdiction over these instruments. In those jurisdictions where we have not been foreclosed judicially from enforcement action, we continue to move aggressively against retail forex fraud. We also cooperate with state, local and other federal authorities to bring a halt to this activity.

We ask Congress to clarify our authority to regulate these instruments so that we may provide a stronger deterrent to fraud and abuse while providing a zone of comfort and rational oversight to legitimate enterprises that want to offer foreign currency contracts to the public.

* * *

While examining the applicability of the Act to OTC markets, we also have conducted an inquiry into whether our current regulatory scheme is appropriately tailored to today's environment for exchange-traded futures. During the past several months, the agency has undertaken a serious effort to answer the question: what degree of exchange-traded regulation is necessary to serve the public interests entrusted to us?

This inquiry is at the heart of the process that the CFTC has engaged in over the last several months. A strong consensus exists among ourselves, Congress and the Working Group that such a review is needed.

Impending technological changes require the CFTC to scrutinize the continued vitality and viability of its one-size-fits-all regulatory structure that currently applies to all futures transactions. While that process is not yet complete, certain clear principles have emerged: one, the historic needs of traditional physical commodities should not be the basis for regulating every futures contract traded today; two, institutional market participants do not require all of the protections designed for retail traders.

Although I will not get into much detail here, let me say that at its core, this plan will afford market participants the opportunity to operate in a regulatory environment suited to the product traded and the participants trading it. The key policy elements of this plan include a move from direct to more oversight regulation; a move from prescriptive rules to flexible performance standards; and the increased use of disclosure-based regulation.

This plan will not impair the agency's ability to assure the fundamental market integrity that is expected when conducting futures exchange transactions in the United States, or when relying upon the prices set in US exchange-traded markets. The Commission will continue to exercise its authority to oversee their continued integrity.

* * *

In conclusion, Mr. Chairman, time is not our ally in establishing a framework that achieves our national economic priorities with respect to derivatives trading. Technology has made it increasingly easy to establish rival markets in foreign jurisdictions; technology has also n increased the speed with which new innovations are introduced and widely used by market participants. Because of these realities, I ask Congress to act expeditiously on the recommendations of the Working Group.

Thank you again for the opportunity to testify before you today. I look forward to continued collaboration with the rest of the Group and the members of this Committee to see these recommendations enacted into law this year.

TESTIMONY OF

ANNETTE L. NAZARETH, DIRECTOR
DIVISION OF MARKET REGULATION
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING THE REPORT TO CONGRESS ON
OVER-THE-COUNTER DERIVATIVES MARKETS
AND THE COMMODITY EXCHANGE ACT BY THE
PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS

BEFORE THE COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY

UNITED STATES SENATE

FEBRUARY 10, 2000

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY OF

ANNETTE L. NAZARETH, DIRECTOR
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BEFORE THE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY
UNITED STATES SENATE

FEBRUARY 10, 2000

Chairman Lugar and Members of the Committee:

I am pleased to appear today to testify on behalf of the Securities and Exchange Commission ("SEC" or "Commission") as you consider issues pertaining to the reauthorization of the Commodity Futures Trading Commission ("CFTC"). My testimony focuses on the Report on Over-the-Counter Derivatives Markets and the Commodity Exchange Act[1] ("OTC Derivatives Report"), which the President's Working Group on Financial Markets ("Working Group") submitted to Congress last November.[2]

As you know, the application of the Commodity Exchange Act ("CEA") to transactions involving over-the-counter ("OTC") derivative instruments raises significant questions of public policy. The Commission has welcomed the opportunity to study some of these questions in coordination with other members of the Working Group. The rapid evolution of OTC derivatives markets requires a regulatory approach that promotes greater legal certainty as well as innovative financial instruments. The Working Group's Report and its recommendations represent an important step toward this goal.

I. The Growth of OTC Derivatives Market

It is widely recognized that OTC derivative instruments are important financial management tools that, in many respects, reflect the unique strength and innovation of American capital markets. Indeed, U.S. markets and market professionals have been global leaders in derivatives technology and development.

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1 Report of the President's Working Group on Financial Markets, Over-the-Counter Derivatives Markets and the Commodity Exchange Act (Nov. 1999).

2 The Working Group includes the Secretary of the Department of the Treasury ("Treasury") and the Chairmen of the Federal Reserve Board, the SEC, and the CFTC.

OTC derivative instruments provide significant benefits to corporations, financial institutions, and institutional investors by allowing them to isolate and manage risks associated with their business activities or their financial assets. These instruments, for example, can be used by corporations and local governments to lower funding costs, or by multinational corporations to reduce exposure to fluctuating exchange rates. Because of the range of benefits these products offer, the OTC derivatives market has grown tremendously during the past two decades. According to data from the Bank for International Settlements, at the end of June 1999, the total estimated notional amount of outstanding OTC derivative contracts was $81.5 trillion.[3]

II. Findings and Recommendations of the OTC Derivatives Report

In preparing the OTC Derivatives Report, the Working Group's task was fairly specific: to focus on how a particular piece of legislation, the CEA, might be modified to address issues related to OTC derivatives markets. Accordingly, the Report makes recommendations in several areas.

A. Swap Agreements

Regulators have focused on the treatment of swaps for over a decade. In 1989, the CFTC issued a Policy Statement, noting that "most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the [CEA] and regulations."[4] After receiving exemptive authority under the Futures Trading Practices Act of 1992,[5] the CFTC followed up with its 1993 Swap Exemption.[6] Notwithstanding the Exemption's relief for some transactions, concerns arose about its scope. Because Congress did not explicitly determine whether swaps fell under the CEA absent such an exemption, the status of swaps remains unclear.

In light of this legal uncertainty, the OTC Derivatives Report recommends that Congress amend the CEA to exclude bilateral swap agreements (other than transactions involving non-financial commodities with finite supplies) between eligible swap participants, acting on a principal-to-principal basis, provided that the transactions are not conducted on a multilateral transaction execution facility ("MTEF").[7] The Commission believes that *excluding* qualifying

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3 The Global OTC Derivatives Market at end – June 1999, 45/1999E (Nov. 25, 1999) <http://www.bis.org/press/index/htm>.

4 Policy Statement Concerning Swap Transactions, 54 FR 30694 (July 21, 1989).

5 Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat. 3590.

6 Exemption for Certain Swap Agreements, 58 FR 5587 (Jan. 22, 1993) (codified at 17 C.F.R. pt. 35).

7 The CFTC has explained that an MTEF "is a physical or electronic facility in which all market makers and other participants have the ability to execute transactions and bind both parties by accepting offers which are made by one member and open to all

instruments from the CEA should create greater legal certainty than the current approach that merely provides for the possibility of exemption, thus leaving open the question of whether such instruments are futures.

B. Electronic Trading Systems

In addition to focusing on the regulatory treatment of particular instruments, the OTC Derivatives Report explores questions raised when electronic systems facilitate the trading of OTC derivatives. It is worrisome that legal uncertainty might hinder technological development in the OTC derivatives market since technological innovation could promote transparency and efficiency. Moreover, the use of technology could help firms to apply more reliable internal controls on traders and to reduce risk.

The OTC Derivatives Report therefore recommends that Congress amend the CEA to exclude certain types of electronic trading systems for derivatives, provided that the systems limit participation to sophisticated counterparties trading for their own accounts and are not used to trade contracts that involve non-financial commodities with finite supplies. Systems clearly not covered by the definition of MTEF in the current Swap Exemption would be covered by this exclusion. The exclusion would also cover systems that assist eligible swap participants communicating about or negotiating bilateral agreements. In addition, the exclusion would cover systems (including ones where bids and offers are open to all participants) where: first, the system only allows participants to act solely for their own account, and, second, the system is not used to enter into agreements requiring a party to make physical delivery of a non-financial commodity with a finite supply.

Moreover, to avoid disadvantaging existing futures and commodities exchanges, those exchanges designated by the CFTC as contract markets also would be permitted to establish these kinds of electronic trading systems for swaps.

C. Clearing Systems

Like electronic trading systems, clearance systems for OTC derivatives transactions are subject to legal uncertainty. Because of their importance, the OTC Derivatives Report recommends that Congress enact legislation to regulate clearing systems used for OTC derivatives. More specifically, the SEC, the CFTC, another federal regulator, or a foreign financial regulator satisfying appropriate standards would regulate clearing systems for OTC derivatives.

Clearing systems that clear futures, commodity options, and options on futures could also clear OTC derivatives (other than OTC derivatives that are securities), subject to CFTC

(...continued)

members of the facility." Exemption for Certain Swap Agreements, 58 FR 5587 (Jan. 22, 1993).

oversight. In addition, clearing agencies subject to SEC oversight could clear OTC derivatives other than instruments involving non-financial commodities with a finite supply. Under the Working Group proposal, legislation would authorize the CFTC to develop rules for the establishment and regulation of clearing systems for OTC derivatives involving non-financial commodities with a finite supply (to the extent they are exempted by the CFTC in a manner allowing clearing). All other OTC derivative clearing systems would need to organize as a bank, bank subsidiary or affiliate, or Edge Act corporation that would be subject to the supervisory jurisdiction of the Federal Reserve or the Office of the Comptroller of the Currency.

The OTC Derivatives Report also recommends that a clearing system subject to regulation by one agency should not become subject to regulation by another agency by virtue of clearing OTC derivatives. Finally, the Report recommends allowing clearing through foreign clearing systems supervised by foreign financial regulators that the appropriate U.S. regulator has determined satisfy appropriate standards.

Hopefully, this framework will encourage the development of clearing systems for OTC derivatives products.

D. The Treasury Amendment

The OTC Derivatives Report also focuses on providing greater certainty for instruments covered by the Treasury Amendment. The Treasury proposed this amendment in 1974 out of concern that the broad statutory definition of "commodity" would subject OTC markets in government securities and foreign currency to CEA regulation. Accordingly, the amendment excludes a list of instruments from the definition of commodity. These listed instruments, however, still may be subject to CEA regulation when traded on a "board of trade." By proposing to replace "board of trade" with "organized exchange," the OTC Derivatives Report seeks to more clearly delineate the parameters of the limitation on the exclusion.

The OTC Derivatives Report further recommends that the Treasury Amendment be clarified to allow the CFTC to address problems associated with foreign currency "bucket shops." Transactions in foreign currency futures and options would be subject to the CEA if entered into between a retail customer and an entity that is neither regulated or supervised by the SEC or a federal banking regulator nor affiliated with such a regulated or supervised entity.

E. Hybrid Instruments and CFTC Exclusive Jurisdiction

Although the members of the Working Group did not reach consensus in the OTC Derivatives Report that all hybrid instruments should be entirely excluded from the CEA or that a hybrid instruments rule needs to be codified at this time, the CFTC has agreed that it will not propose any new rule about hybrid instruments without the concurrence of the other Working Group members. This decision reflects recognition of the interests of the SEC and bank regulatory agencies in this area. These interests arise because hybrid instruments possess characteristics of securities and bank products.

The OTC Derivatives Report, however, urges Congress to clarify that the Shad-Johnson Accord should not be construed as applying to hybrid instruments that have been exempted from the CEA.

Finally, over the years, the clause in the CEA granting the CFTC "exclusive jurisdiction" over certain matters has caused confusion. Questions have been raised over the appropriate regulator and regulatory scheme for complex derivative instruments possessing attributes of securities and futures contracts. All Working Group members agreed to recommend amending the CEA to explicitly clarify that insofar as hybrid instruments may be subject to the CEA, the exclusive jurisdiction clause shall not be construed to limit the authority of the SEC and the bank regulatory agencies with respect to such instruments.[8]

F. Other Issues

1. Single Stock Futures

The unanimous findings of the OTC Derivatives Report reiterate the Commission's position that although single stock futures may possess elements of traditional futures contracts, they also have the characteristics of traditional securities. Accordingly, when considering the Shad-Johnson Accord's[9] ban on single stock futures, one must recognize that regulatory issues associated with the introduction of such products would be complex. Indeed, the members of the Working Group agree that numerous issues — including but not limited to margin levels, insider trading, sales practices, real-time trade reporting, floor broker activities, and CFTC exclusive jurisdiction over futures contract markets — would have to be resolved before the ban could be reconsidered.

As you know, Chairmen Lugar and Gramm both asked that the SEC and the CFTC report back to their respective committees later this month on issues associated with modifying the Shad-Johnson Accord.[10] The Commission staff have been working diligently with their counterparts at the CFTC to review the relevant issues. We look forward to sharing our views with the Committee on these issues when our Report is submitted.

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8 The Commission, Treasury, and the Federal Reserve Board believe that the exclusive jurisdiction clause should apply only to transactions in futures contracts or options on futures contracts effected on designated contract markets, and that the clause should be clarified by providing that the CFTC's jurisdiction over such transactions is not exclusive in instances where the CEA or some other federal statute specifically grants another agency authority.

9 Futures Trading Act of 1982, Public Law No. 97-444, 96 Stat. 2294-97.

10 Letter from the Honorable Richard Lugar, Chairman, Senate Committee on Agriculture, Nutrition, and Forestry and the Honorable Phil Gramm, Chairman, Senate Banking Committee, to the Honorable Arthur Levitt, Chairman, SEC, and the Honorable William Rainer, Chairman, CFTC (Dec. 17, 1999).

2. Regulatory and Tax Arbitrage

The Report recognizes that derivative products may be tailored to circumvent regulation or tax consequences that would apply to other financial products. The Commission endorses the Working Group's view that, in most instances, the way to address regulatory arbitrage is to amend underlying statutes and regulations that most closely pertain to the regulatory goal to be achieved.

3. Netting

With respect to netting, the Commission supports the Working Group's reiteration of the need for improvements in the close-out netting regime for derivatives and other financial instruments under the Bankruptcy Code and bank insolvency law. The Working Group's April 1999 report, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management ("Hedge Fund Report"),[11] previously recommended this course.

4. Derivatives Dealers

The OTC Derivatives Report also reiterates a recommendation from the Hedge Fund Report regarding certain derivative dealers. Generally, derivatives dealers enter into derivatives contracts with end users and other dealers. Such dealers may use OTC derivative instruments to hedge their own financial risk, and most in the U.S. are banks or bank affiliates or affiliates of broker-dealers or futures commission merchants ("FCMs"). Although banking regulators supervise the banks and their affiliates, most affiliates of broker-dealers and FCMs remain unregulated.[12]

For OTC derivatives dealers, private counterparty discipline is now the primary mechanism for limiting potential losses from counterparty defaults and reducing systemic risk. The OTC Derivatives Report calls for government regulation to supplement, but not substitute for, private market discipline. Both regulated and unregulated OTC derivatives dealers have employed private counterparty credit risk management, and some tools exist for federal regulators. As the Hedge Fund Report noted, however, limitations on SEC and CFTC access to information about the activities of unregulated affiliates of broker-dealers and FCMs create a gap in financial market oversight. Thus, the Hedge Fund Report called for Congress to provide the

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

12 The SEC and CFTC possess limited authority to obtain information about such affiliates' activities, and the SEC has instituted a special regulatory scheme for derivatives dealers conducting a limited securities business. Some U.S. derivatives dealers are affiliated with entities, such as insurance companies, finance companies, and public utilities, that are not subject to banking or securities regulation.

SEC and CFTC with enhanced authority to obtain risk assessment information. The OTC Derivatives Report reiterates this recommendation.[13]

III. Conclusion

The OTC Derivatives Report only represents a beginning. In addition to implementing the Report's recommendations, we must continue to study the OTC derivatives market as it develops. With input from Congress and industry participants, I feel confident that we can meet any regulatory challenges while allowing the efficient development of this market.

The rapid evolution of OTC derivatives markets requires a regulatory approach that promotes greater legal certainty as well as innovative financial instruments. The OTC Derivatives Report represents a balanced approach. The Commission appreciates the opportunity to consider these issues, and looks forward to interacting with the Working Group, your Committee, and other legislators as they consider implementation of changes recommended in the OTC Derivatives Report.

I would be happy to answer any questions you might have.

[13] The OTC Derivatives Report also notes the need to continue monitoring the development of derivatives dealers that are unaffiliated with banks, broker-dealers, or FCMs.

CBOT

Testimony of David P. Brennan
Chairman of the Chicago Board of Trade
Before the Senate Committee on Agriculture, Nutrition and Forestry

February 10, 2000

Testimony of David E. Brennan

Chairman

Board of Trade of the City of Chicago

On the President's Working Group of Financial Markets Report on
Over-the-Counter Derivatives Markets and the Commodity Exchange Act

Before the Senate Committee on Agriculture, Nutrition, and Forestry

February 10, 2000

Mr. Chairman and members of the Committee, I am David Brennan, Chairman of the Chicago Board of Trade. Accompanying me today is Thomas R. Donovan, Chief Executive Officer and President of the Board of Trade. We welcome the opportunity to discuss with you the ramifications of the November 1999 Report of the President's Working Group on Financial Markets. Thank you for conducting this hearing.

The Report of the President's Working Group addressed a basic issue: whether the only federal statute that is designed to regulate derivatives transactions – the Commodity Exchange Act – serves today's derivatives markets well. The Working Group concluded that the answer is "no." Federal law has not kept up with the almost $100 trillion dollar derivatives markets. To that end, the Report recommended a series of amendments to the Commodity Exchange Act which would allow that statute to serve better the objectives of enhanced market efficiency, innovation, and fair competition, while also preventing the negative market forces of legal uncertainty and systemic risk. The Working Group concluded that if these objectives are met, the U.S. derivatives markets would be able to maintain their global leadership position.

The Board of Trade strongly endorses each of these objectives and has long recognized the need for a sweeping overhaul of the Commodity Exchange Act. This overhaul should be the congressional mission as we approach CFTC Reauthorization this year. From our perspective, "fair competition" is the critical issue. Markets should be open so that all may compete. To the extent any government oversight is necessary, similar products offered to similar customers in similar circumstances should have similar oversight. The Working Group Report acknowledges these concerns and builds into its recommendations a framework for removing the current barriers to fair competition.

For the U.S. futures exchanges, a key ingredient to achieving this competitive balance is regulatory reform. The Working Group Report stated generally that "Where regulation exists, it should serve valid public policy goals." In particular, the Working Group found that "*Exchange trading should not be subject to regulations that do not have a public policy justification.*"

These principles have been embraced by CFTC Chairman William Rainer and his agency. Under his leadership, they are working on a plan to rationalize regulation under the CEA in a manner that would be consistent with the framework recommended in the Working Group Report. While the details of the Commission's approach are not yet complete, the Board of Trade is very appreciative of the energy and creativity the Commission has devoted toward modernizing its regulatory stance. We look forward to learning more about the Commission's regulatory restructuring agenda and to working cooperatively with Chairman Rainer and the Commission in this effort.

In addition to encouraging the CFTC to rethink its regulatory approach, the Working Group Report recommended the enactment of a series of amendments to redraw the boundaries of the Commodity Exchange Act. Drawing such lines is both a necessary and inherently dangerous practice. Every day as technology changes, derivatives markets change. Asking federal law to anticipate or keep up with those changes is a tall order. For those reasons, the Board of Trade questions some of the jurisdictional lines the Working Group would draw. I will outline those areas in this testimony. But I do not want our observations to obscure the Board of Trade's support for the objectives identified by the Working Group or its recommendations to facilitate innovation and fair competition in derivatives markets. They have produced a starting point that will serve as a valuable catalyst to congressional consideration of the issues presented by CFTC Reauthorization this year.

Background

The Working Group frames its analysis by distilling the current derivatives market into two main types -- swaps and futures. At their roots, swaps and futures have many similarities. Both markets are traded primarily by the same large sophisticated institutions. Both markets are used to hedge or assume the risk of changes in interest rates, currencies, stock or commodity prices. Both markets are large; as measured by the Working Group, the swaps market is at least $80 trillion is size and the futures markets is over $13 trillion. In both markets, the most popular types of transactions involve changes in interest rates.

The Report notes that historically, futures and swaps also have had material differences. Futures were traded on exchanges. Swaps were not. Futures were standardized trading instruments. Swaps were customized and privately-negotiated. Futures were available to retail customers. Swaps were not. Futures were subject to the protection of clearing systems. Swaps were not. Futures were subject to regulation under the Commodity Exchange Act. Swaps were not.

The Working Group correctly understood that markets do not stand still, however. Today, some swaps are standardized, fungible, traded in centralized electronic markets or subject to clearing. And some futures are customized, or at least not standardized. This market convergence has substantially blurred the definitional lines between swaps and futures, as the Working Group acknowledges. Thus, in forming its recommendations, the Working Group Report used the term "derivative" transactions – a term that covers both futures and swaps – in order to reflect the comprehensiveness of its recommendations.

That is a very healthy start to the debate. In the past, too much energy has been wasted trying to analyze whether swaps fit the legal definition of futures contracts. Both sides made persuasive arguments and no legal consensus has emerged. But that well-worn issue should now be beside the point. The questions framed for Congress by the Working Group wisely extend beyond those artificial labels and in the most simplified form are:

- what derivatives should be excluded from the Commodity Exchange Act?
- what derivatives should be subject to the Commodity Exchange Act?
- what level of regulation or oversight should apply to those derivatives that are subject to the Commodity Exchange Act?

Principal Areas of Agreement

The Working Group's analysis started from the premise that not every derivatives transaction needs to be regulated. The Board of Trade completely agrees.

The Working Group then reasoned that regulation, if it exists at all, should serve valid public policy goals. The Board of Trade completely agrees.

The Working Group concluded that any clearing system for derivatives should be subject to separate oversight regulation at the federal level, including under the Commodity Exchange Act. The Board of Trade completely agrees.

The Working Group determined that a large class of derivatives transactions should not be subject to the Commodity Exchange Act and found that the statute needs to be amended to provide those transactions with legal certainty. The Board of Trade completely agrees.

The Working Group recognized that excluding a large class of derivatives transactions from oversight under the CEA could remove those transactions from any form of federal regulation and therefore has competitive implications for those transactions that remain subject to the CEA, including derivatives traded on organized futures exchanges. The Board of Trade completely agrees.

The Working Group stated that these competitive implications should cause the CFTC to reconsider its regulatory approach in an effort to transform itself into an oversight agency, rather than a front-line regulator. The Board of Trade completely agrees.

The Working Group acknowledged that the CFTC and the Securities and Exchange Commission should reassess whether the ban on single stock futures in the Shad-Johnson Accord should be lifted. The Board of Trade completely agrees -- and has for the past 18 years, while this self-described "temporary foreclosure" was serving as an absolute and unwarranted competitive barrier for exchange-traded futures in the United States.

The Working Group decided that a statutory line should be drawn so that the markets know with certainty what transactions are excluded from the CEA. The Board of Trade completely agrees. Our questions go to where that line should be drawn.

The Working Group's Factors

The Working Group would exclude from the CEA any

- financial derivative;
- traded only among institutions;
- on a "principals only" basis (no direct agency trades);
- on a bilateral execution facility or an electronic multilateral execution facility; unless
- the market serves a price discovery function.

Put another way, any financial derivative, even if standardized and fungible (like traditional exchange-traded derivatives), traded among institutions acting as principals on a centralized electronic execution facility would be removed from the statute's coverage. It should go without saying that this is a broad exclusion. Indeed, the Working Group conceded that the breadth of this exclusion blurs the historical distinctions between exchange-traded products that are subject to regulation under the CEA and those over-the-counter derivatives that are not.

In addition, the Working Group would even more broadly exclude from the CEA any derivative in or involving foreign currency or government securities, which is not traded on an "organized exchange." To be excluded from the "organized exchange" category, an exchange would need to either 1) bar retail customers and agency trades for institutional customers or 2) Renounce its self-regulatory obligations.

The Working Group's revised Treasury Amendment would change the landscape of federal regulation drastically. It would mean that the Chicago Board of Trade's markets in Treasury Bond and Note futures and options -- which account for about 75% of our business -- could be excluded from the "organized exchange" definition and the Commodity Exchange Act. How? We could enact a rule requiring all trades executed on the exchange floor to be on a principals only basis so that trading for any customer could be pursued off the exchange floor in a manner similar to dealer market practices. In the alternative, the Board of Trade could just disband its self-regulatory forces, including its Office of Investigations and Audits, thereby qualifying as a "non-organized exchange" in order to avoid regulation for three-quarters of our business. Thus, the "organized exchange" definition could lead to dramatic changes in derivative market regulation if enacted.

The underlying public policy rationale and logic for these exclusions is questionable. Let me summarize our concerns, one at a time.

Financial Derivatives

The Working Group Report claimed that since financial derivatives pose less of a threat of manipulation than non-financial derivatives, financial derivatives should be eligible for exclusion from CEA regulation. We agree that the relative threat of manipulation of a type of derivative is a relevant consideration. We are less convinced that the right way to address that "relativity" is an "all or none" decision resulting in a selective regulatory exclusion for some financial derivatives, but not those traded on traditional exchanges, for example.

In our view, tailoring the necessary surveillance of any publicly-traded derivative product to the actual threat of a manipulation is better than awarding a statutory exclusion to those products that are unlikely to be manipulated and traded other than on a traditional exchange. If no possible threat of manipulability exists for a particular type of publicly traded derivative -- whether based on an agricultural commodity or a financial instrument -- then no trading surveillance should be needed. But other types of oversight may be appropriate for those publicly traded derivatives, including the fitness of the operator of the derivatives execution facility as well as fraud and financial integrity for intermediaries. In short, a reduced threat of manipulation does decrease the need for oversight, but it doesn't eliminate it in all areas. And all publicly traded derivatives transactions should be treated alike.

In addition, it will be difficult to decide what transactions are "financial derivatives." Certainly the vibrant over-the-counter energy derivatives sector will contend that their instruments should be considered to be "financial." And one could expect those that offer and trade over-the-counter equity swaps – derivatives tied to stock indexes or single stock prices – to claim that they fall within the term "financial derivative." If so, the carve-out for qualifying financial derivatives plainly has implications for the Shad-Johnson ban on single stock futures and other related issues.

In the past, in the context of our ProMarket proposal, the Board of Trade itself has proposed treating financial and non-financial derivatives in a disparate manner. Some observers, including members of this Committee, criticized us for that approach. To the extent those criticisms are valid, they are equally applicable to the Working Group's Report – the nature of the "commodity" underlying a derivative may be a problematic criterion for determining a statutory exclusion.

Institutions Only vs. Institutions Mostly

The Working Group Report concluded that derivatives transactions entered into by and between only sophisticated institutional market participants may be excluded from the Commodity Exchange Act. The rationale is that institutions need less federal-regulatory protections than non-institutional market participants do. That is true, but again a complete exclusion may not be the right answer. Today our exchange markets are not "institutions only" markets. We operate "institutions mostly" markets where 95% or more of the trades are for parties who would be considered to be institutions that are eligible to trade excluded derivatives under the Working Group's recommendation. So if our exchange markets barred the retail customer (no more than 5% of our market), fairness would dictate that exchange markets too should be eligible for the exclusion.

But why? The retail customer comes to our markets only when represented by a regulated intermediary who must act on behalf of the retail customer. That regulated intermediary makes sure that the customer understands the risks of trading and complies with the financial integrity protections. That regulated intermediary either executes the order itself acting as a broker or retains a regulated floor broker who will actually execute the customer's trade.

For purposes of executing a customer trade, the customer's identity is not relevant. It doesn't matter whether the customer order is for Donald Trump or Donald Duck, the IBM Pension Fund or Joe Q. Public. All the broker knows is that he or she represents a customer and is obliged to fill every customer order at the best price. For transaction execution purposes, retail customers are treated the same as institutional customers. So why exclude from the CEA "institutions only" execution facilities, but not "institutions mostly" execution facilities?

Enacting exclusionary standards that will encourage the creation of markets with pools of liquidity that will be the sole province of institutions will, in fact, disadvantage retail customers. Put simply, public customers are not likely to get the best prices available without access to the best pools of liquidity. We therefore question the wisdom of setting up a regime that could segregate the retail customer from the best markets, especially where a regulated intermediary is handling the execution of the customer's traded.

Again, our ProMarket proposal was criticized by some on just this ground. We like to think we have learned from that criticism. Congress should not adopt standards that could operate to deny retail customers access to the most liquid trading markets or execution facilities.

Principals Only vs. Agency and Principal Markets

Markets are made up of two types of trades -- Principal and Agency. A Principal trade occurs when a party enters into a trade for its, his or her own account. An Agency trade occurs when one party enters into a trade for someone else (a customer).

The Working Group Report recommended that only Principal trades be eligible for exclusion from the CEA. The reasoning was that there is little federal regulatory interest when two institutions trade with each other for their own account. On one level, we have no quarrel with that position. That is why the Board of Trade, along with the Chicago Mercantile Exchange and New York Mercantile Exchange, have endorsed an exclusion from the statute for privately negotiated transactions between two institutional parties.

But the Working Group Report would go beyond that class of private transactions to exclude, for example, a centralized electronic "dealers only" market for trading derivatives. That would mean that in each dealer's back office, it could trade directly with its institutional customers at prices based upon, and reflecting a markup of, the centralized "dealers only" market price and still qualify for the exclusion. What the dealer could not do is try to get its institutional customers the best price by entering an order on behalf of the institution directly in the centralized electronic market.

Again, the Working Group Report would encourage the creation of markets that are "off limits" to many market participants, at least directly. Fragmenting trading markets should be discouraged, not encouraged.

Electronic vs. Pit Trading

The Working Group Report would exclude from regulation under the CEA standardized, fungible derivatives traded on a principal basis among institutions if trading occurs on a multilateral electronic or computerized trading facility. This policy is followed to encourage the development of electronic trading mechanisms.

Under that recommendation, however, if that same derivatives contract is traded on the same basis by the same institutions in a pit trading or inter-dealer broker phone and fax environment, that trading activity would suffer full-scale regulation under the CEA. No basis exists for that disparity. We question whether it is fair or sensible to mandate that regulatory exclusions will turn on the nature of the execution mechanism selected. We would recommend, as a business that operates in both a pit trading and electronic trading environment, that regulatory coverage be based on market neutral concepts. Congress should not tip the competitive scales in one direction or another; if it decides to enact a regulatory exclusion for multilateral transaction execution facilities, that exclusion should treat electronic and physical trading environments alike.

In this regard, the Working Group's Report is a bit inconsistent. In the Treasury Amendment area of derivatives trading, the Working Group is willing to treat electronic and pit trading alike. For all other forms of financial derivatives, the Working Group would exclude only multilateral *electronic* execution facilities. Again, we would recommend that Congress adopt a neutral, even-handed approach to execution facilities. We also question whether Congress needs to add an extra and potentially confusing exclusion for Treasury Amendment products. One exclusion that is well thought out and stated unambiguously is much better than two exclusions that could promote inconsistent policy outcomes.

Price Discovery

The Working Group Report suggested that in some instances excluded transactions could become subject to the CEA if those transactions resulted in or contributed to price discovery. The concept of price discovery requires careful definition, especially in an increasingly integrated, technologically linked global economy. Through the Internet, all sorts of disparate derivative and cash market pricing data -- for financial and agricultural markets -- are linked in ways never before possible, providing a new paradigm of price discovery. Even if that were not the case, to the extent price discovery is meant to include price basing, the Report's exclusion may not provide the same measure of legal certainty to many market participants since certain plain vanilla OTC transactions have, or may, become the source for price basing in many financial areas.

It is true that the Commodity Exchange Act was enacted many decades ago in part to protect the integrity of the price discovery process. But that concern arose in an economic era where centralized markets frequently generated the only reliable pricing benchmark available by telegraph or telephone. In the markets of the 21st century, whether agricultural or financial, it is likely that technology will link together many disparate transaction execution facilities or other forms of markets, thereby providing market participants with a variety of pricing reference points. If regulatory coverage decisions turn on that kind of price discovery, again the goal of legal certainty will be seriously compromised.

Fair Competition

One objective of the Working Group Report was to develop regulatory coverage principles that would promote fair competition. In two specific areas, the Report's recommendations seem to fall short of that objective.

Clearing. The Working Group recommended that Congress enact legislation to provide a clear basis for the regulation of clearing systems for derivatives that are otherwise excluded from the Commodity Exchange Act. The Working Group believed that the clearing of otherwise excluded derivatives should be subject to oversight on a "pick your regulator" basis. The choices are the CFTC (but not for derivatives that are securities), the SEC (but not for non-financial derivatives) or the bank regulators. Up to here, the recommendation appears to be fair and even-handed.

The problem comes in when the class of excluded derivatives is considered. As we have seen, under the Working Group's recommendation, fungible and standardized financial derivatives identical to the futures and options now traded on the Board of Trade and Chicago Mercantile Exchange, and subject to their clearing mechanisms, could be excluded from the CEA. Those futures and options contracts by virtue of being considered to be excluded derivatives could now become subject to clearing by a SEC-regulated clearing agency. Yet a CFTC-regulated clearing agency could not clear derivatives, primarily options transactions, which are now subject to oversight by the SEC.

A balanced "pick your regulator" approach should provide a two way street for competition in clearing. Market participants are looking for centralized processing and clearing of all transactions. The Working Group recommendation gives a significant edge to SEC-regulated clearing agencies in this regard by expanding the range of instruments they could clear to cover those instruments now cleared by CFTC-regulated clearinghouses. Without reciprocity, futures clearinghouses will face a severe handicap and be forced to form separate securities clearing agency subject to SEC oversight in order to clear those derivatives that are securities. That is not fair and even-handed competition. Moreover, once such a securities clearing agency is formed by a futures clearinghouse, the operators of that facility may decide to put all its clearing business through the securities clearing affiliate since the securities affiliate will have the flexibility to clear all financial futures, options, securities and derivatives transactions. The futures clearing facility will lack the legal capability. Thus, the Working Group Report offers a roadmap for expanding greatly the range of securities clearing and limiting dramatically the range of futures clearing.

Shad-Johnson. The Working Group did not indicate whether its definition of excluded financial derivatives included "equity swaps" and other forms of derivatives tied to securities prices. We have presumed that equity swaps were intended to be covered by the term "financial derivatives" because equity swaps are the class of instruments most in need of legal certainty under the CEA since they are not included in the CFTC's current swaps exemption. On the other hand, excluding equity swaps from the CEA would mean excluding those instruments from the Shad-Johnson product restrictions, leaving traditional exchange-trading of those instruments to be the only product offerings subject to the ban. That result signals a complete disregard for fair competition.

Consider this. The Report's recommendations would *exclude* from the Shad-Johnson ban a swap tied to the value of IBM stock, where that swap was standardized, fungible, cleared, traded only by institutions and subject to a multi-lateral electronic trading facility (just like the Board of Trade's Project A). At the same time, the Report also suggested that the "current prohibition on single-stock futures (for example, futures tied to the value of IBM stock) can be repealed if issues about the integrity of the underlying securities market and regulatory arbitrage are resolved." Does that mean that if an IBM future was traded only among institutions and was standardized, fungible, cleared and traded only on an electronic trading facility like Project A it would not present any issues relating to the integrity of the underlying securities market and regulatory arbitrage? The Report doesn't say, but it suggests the answer is "no." Otherwise its discussion on Shad-Johnson would be superfluous since it seeks merely to initiate reconsideration of the Shad-Johnson issue, not resolve it.

In summary, the Working Group Report appears to be excluding equity swaps from Shad-Johnson. To reach that result, the Working Group is elevating form over economic substance by treating an instrument labeled a "swap" as excluded from Shad-Johnson and the same instrument labeled a "futures contract" as banned under Shad-Johnson. Labels should not be determinative of these important issues of regulatory policy, as the Working Group makes clear in the other areas of its report.

The U.S. futures exchanges have been urging Congress to reconsider and lift the Shad-Johnson ban since 1982. We have agreed that the same kind of margin and insider trading rules should apply to stock futures as apply to stock options. We don't want a regulatory advantage. We just want an opportunity to compete.

The Shad-Johnson ban places U.S. markets at a serious competitive disadvantage to our foreign competitors as well. They can, and many do, offer single stock futures. We can't.

That anomalous result is best illustrated by this example. As you know, the Board of Trade has entered into a joint venture with the German-Swiss exchange EUREX to develop an electronic trading platform. As part of that agreement, EUREX may not list futures on U.S. stocks without the Board of Trade's consent. If the Shad-Johnson ban on single stock futures is not lifted, the Board of Trade could have no choice but to consent to the listing of futures on U.S. stocks on EUREX allowing investors all over the world, except in the U.S. where Shad-Johnson applies, to trade those instruments. The Board of Trade could share in the transaction fee for each execution, an important consideration as we move to a for-profit environment. But no U.S. investors could trade in that global market in single stock futures on U.S. stocks. That makes no sense.

The Working Group Report deserves considerable credit for trying to jump-start a meaningful dialogue that should lead to allowing single stock derivatives, including futures, to be traded in the U.S. A main purpose of the Working Group Report is to open up markets for healthy competition by removing unneeded regulatory barriers. The Shad-Johnson ban is such a barrier; Congress should repeal the Shad Johnson product restrictions.

Conclusion

The Working Group Report has outlined the principal elements of a CFTC Reauthorization bill. Congress must enact clear lines of demarcation for those derivatives that are not, and are, subject to the CEA. Regulatory modernization for those transactions that are subject to the CEA must be codified to provide for oversight, not micro-management, designed to serve valid public policy goals. Finally, Congress must repeal all unwarranted barriers to competition, like the Shad-Johnson product restrictions.

As always, filling out that outline with the details of specific legislative solutions will be a challenge. But a seemingly strong consensus has emerged that the Working Group has identified the correct ingredients for a successful legislative package. As we say often in the context of restructuring the Chicago Board of Trade, the status quo is not an acceptable alternative. We need to move and move quickly to restructure federal regulation to enable all derivatives markets to benefit from the forces of full and fair competition. The Board of Trade looks forward to working with you, Mr. Chairman, and this Committee to get the work done to help create legislation that will accomplish the important national goals the Working Group has set out.

New York
Mercantile Exchange
NYMEX/COMEX. Two divisions, one marketplace

Statement of Daniel Rappaport, Chairman
New York Mercantile Exchange
Before the
United States Senate
Committee on Agriculture, Nutrition and Forestry
February 10, 2000

Mr. Chairman, and members of the Committee, my name is Daniel Rappaport. I am Chairman of the Board of Directors of the New York Mercantile Exchange ("NYMEX" or the "Exchange"). NYMEX is the world's largest exchange for the trading of energy and metals futures and options contracts. NYMEX also offers trading in certain foreign equity index futures and option contracts.

On behalf of NYMEX, I wish to thank you for the opportunity to participate in today's hearing on the report prepared by the President's Working Group on Financial Markets entitled "Over-the-Counter Derivatives Market and the Commodity Exchange Act" ("Report"). In particular, you have asked for comment on the Report's recommendations concerning the regulation of over-the-counter ("OTC") derivative markets and amendments to the Commodity Exchange Act ("CEA").

The Working Group initiated the Report following a request from Congress[1] and a joint request from the Chairmen of the House and Senate Agriculture Committees.[2] The Working Group was asked to study the OTC markets, develop policy and make legislative recommendations. I will first present an overview of our response before providing comments on specific recommendations in the Report.

OVERVIEW

The Working Group's Report makes a number of thoughtful recommendations for OTC derivatives. These recommendations are based upon the implicit consensus of the Working Group that derivatives trading "should not be subject to regulations that do not have a public policy justification." We strongly support this principle of public policy. This principle should apply to derivatives transactions generally, whether traded in the OTC market or in a market that has been regulated by the CFTC.

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[1]H.R. Rep. No. 825, 105th Cong., 2d Sess. 991-92 (1998).

[2]Letter from the Honorable Richard G. Lugar, Chairman, Senate Committee on Agriculture, Nutrition and Forestry, and the Honorable Robert Smith, Chairman , House Committee on Agriculture, to the Honorable Robert Rubin, Secretary of the Treasury (Sept. 30, 1998).

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Even though the Report's scope is limited by design, the fleeting treatment of exchange-traded derivatives in the Report is nonetheless a cause for concern. The Working Group correctly noted that a number of market participants have concluded that "U.S. futures exchanges are at a competitive disadvantage to OTC derivatives as the result of CEA regulation." Furthermore, the Working Group also observed that market participants believe that initiatives that would introduce electronic trading and clearing for derivatives outside of the CEA, which are both recommended in the Report, could further "exacerbate this perceived imbalance." The Report recognizes the regulatory disparities and blurred product distinctions that unduly restrict U.S. exchanges in today's competitive global market. Yet, while recommending additional regulatory relief for the OTC market, the Report does not directly address the long-standing regulatory dilemmas faced by U.S. futures exchanges.

As a basic principle of public policy, attempts at serious and comprehensive regulatory reform should be fair and even-handed both for OTC and exchange markets. The Report, when viewed on a stand-alone basis as an agenda for legislative reform, falls short of meeting that standard.

In order to promote competition and market efficiency through the exercise of prudent public policy, Congress should make reforms to the CEA for exchange markets at the same time that it undertakes amendments to the CEA pertaining to the OTC market. The need for regulatory relief for regulated U.S. futures exchanges is at least as urgent, if not more so, as the need for legal certainty for the OTC market.

There is now a strong and widely-shared consensus in the financial community that comprehensive reform of the CEA is overdue and is urgently needed. Market users believe that Congress needs to modernize and streamline regulation of exchange-traded derivative transactions. A number of exchange-traded futures contracts, such as NYMEX's Light Sweet Crude Oil futures contract, are highly liquid contracts that are traded almost exclusively by sophisticated institutional traders. For such contracts, there is a critical need to balance regulatory burdens with the regulatory objectives to be achieved from such regulation.

Mr. Chairman, NYMEX believes that this Committee has signaled its commitment to tackling some difficult market disparities. Congress should aim for a fundamentally fair approach in any legislation to reform the U.S. regulatory structure.

We also note that CFTC Chairman William Rainer highlighted his support for serious reform in a speech late last year to industry leaders in Chicago. In a subsequent speech in New York, Chairman Rainer indicated that he had established a CFTC staff task force to review existing regulatory burdens on regulated exchanges and on intermediaries and to consider alternative approaches permissible under the CFTC's current authority.[3] Chairman Rainer further indicated that he hoped to establish an appropriate level of regulation that would make being regulated by the CFTC an attractive business option.

We credit this Committee and the current Chairman and commissioners at the CFTC for their willingness to wrestle with long-standing regulatory disparities, and we hope to work with the CFTC, President's Working Group and Congress to achieve comprehensive reform of the risk management markets.

RESPONSES TO SPECIFIC RECOMMENDATIONS

Exclusion of Financial Swap Transactions from the Commodity Exchange Act

The great majority of swap transactions, as indicated in the Report, involve financial derivatives such as interest rate, foreign exchange and equity products. The Working Group chose to group these products as one financial category to be excluded from the CFTC's jurisdiction.

Specifically, in the Report, the Working Group recommended that Congress create a statutory exclusion from the CEA for bilateral swap transactions between sophisticated counterparties, but specified that this statutory exclusion would not be available for swap transactions involving non-financial commodities with finite supplies.[4] In other words, the proposed statutory exclusion for bilateral swap transactions would be available only for financial commodities. In addition, the restriction on standardized terms for swap agreements contained in current Part 35 of the CFTC's regulations would not be included in this statutory exclusion.[5] Rather than a statutory exclusion for non-financial commodities with finite supplies, the Working Group instead recommended that the CFTC retain its current authority to grant exemptions involving non-financial commodities where exemptions are in the public interest and otherwise consistent with

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[3]Although the CFTC staff report is not yet public, it is our understanding that the staff is conducting an intensive review of current CFTC regulations with a view to making recommendations, consistent with the regulatory objectives of the CEA, that could eliminate unnecessary regulations for certain exchange-traded products and markets.

[4]The Report does not specify what the Working Group meant by the term "finite supplies."

[5]The Working Group further recommended that the CEA be amended to clarify that a party to a transaction may not avoid performance of its obligations under, or recover losses incurred on, a transaction based solely on the failure of that party (or its counterparty) to comply with the terms of an exclusion or exemption under the CEA. NYMEX supports this clarification.

the CEA.

With regard to legal certainty for OTC transactions, NYMEX has consistently supported the CFTC's use of its exemptive authority to create Part 35, which generally exempts bilateral swap transactions between sophisticated counterparties from most provisions of the CEA. We further agree with the Working Group that OTC markets suffer from legal uncertainty that should be resolved by amending the CEA.

Again, however, we believe strongly that addressing this uncertainty is best undertaken in the context of a comprehensive reform of the CEA that is fair and even-handed both for OTC and exchange markets. The Working Group has justified its proposed exclusion by asserting that OTC financial derivatives executed between sophisticated counterparties are determined in a highly liquid market with a very large deliverable supply. The Working Group suggests that these products are not susceptible to manipulation, do not implicate concerns about customer abuses and therefore do not need to be regulated by the CFTC. These same characteristics also apply to a number of futures and option contracts now trading on futures exchanges regulated by the CFTC. Fundamental fairness and due process require that like economic products traded between the same types of counterparties receive comparable regulatory treatment. Thus, these futures and option contracts also should be should eligible for the same light-handed regulatory treatment.

In particular, certain tangible commodities are traded between sophisticated counterparties and involve a highly liquid market and very large deliverable supply. We believe that such commodities do not require the same level of regulation as less liquid contracts that have significant participation by retail customers.

It is probably appropriate to review each physical commodity on a case-by-case basis, and it may be further appropriate to review the characteristics of the markets on which such products are traded. Therefore, we are not opposed to a review process that makes such a determination. However, we believe that Congress should amend the CEA to provide clear guidance to the CFTC that certain contracts, including physical commodities that are traded between sophisticated counterparties and that involve a highly liquid market and very large deliverable supply, are deserving of sweeping changes in their regulatory burden.

Electronic Trading Systems

The CFTC's Part 35 provides an exemption from most CFTC regulatory requirements for swap agreements entered into between eligible swap participants provided that: (a) the swap agreement is not part of a fungible class of agreements that are standardized as to their material economic terms; (b) creditworthiness is a material consideration in entering into the swap agreement; and (c) the swap agreement is not traded on a "multilateral transaction execution facility."

The Working Group recommended that the CEA be amended to permit excluded swap transactions to be traded under certain conditions via electronic trading markets. Specifically, the Working Group recommended that Congress clarify that entering into or trading excluded swap agreements, i.e., transactions between eligible swap participants that do not involve non-financial commodities with finite supplies, through electronic trading systems would not create a basis for regulation by the CFTC, provided that the systems limit participation to sophisticated counterparties trading for their own accounts. The Working Group's recommendations to omit the restriction on fungible instruments from the terms of the proposed statutory exclusion and to permit swaps to be traded on electronic trading facilities would thus eliminate two of the key regulatory conditions that have been applicable to eligible swaps under Part 35.

Earlier in the Report, the Working Group noted that, because certain instruments serve risk-management needs of a large number of market participants, "the extent to which market participants engage in large numbers of transactions increases." Indeed, not only is it the case that most of the business engaged in by OTC market participants involves standardized product specifications, but these product specifications often are blatantly identical to the terms and conditions of parallel futures contracts traded on regulated futures exchanges. Swap agreements provide for an opportunity to negotiate the terms of the swap agreement, such as credit terms. However, as the Report also noted, "in practice this opportunity may not be used to a great extent . . . ." In other words, the line separating swap agreements from exchange-traded futures transactions is becoming less and less distinct each day. To that extent, this dividing line is now less a product of the characteristics of the instruments themselves and more a function of their regulatory treatment.

To allow swap transactions to be traded on a centralized electronic trading facility would largely obliterate this dividing line. It also would appear to create the same policy interests that have been thought to be applicable to regulated futures exchanges.

The Working Group, by suggesting that excluded swaps be permitted to be traded on electronic trading systems, is asking Congress to create explicit statutory preferential regulatory treatment for one type of financial instrument, swap agreements, over an equivalent financial instrument that is already trading on a regulated exchange.[6] If Congress was to follow that advice, it would be setting itself up to decide which financial instruments should be allowed to thrive and which instruments should be curtailed.

Rather than having Congress dictate this result by its apportioning of regulatory burden, we suggest that the more appropriate role for Congress would be to ensure a

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[6]The Report recommended that futures exchanges be permitted to establish electronic trading systems for qualified swaps. However, this concession is outweighed by the harm posed by the proposed preferential treatment for swap agreements.

level regulatory playing field for comparable products and let the market decide. Establishing public policy on a principled basis requires consistency in regulatory treatment for entities for which no real regulatory distinction can be drawn. Therefore, derivatives that are labeled as futures and are traded on centralized electronic trading systems should receive the same regulatory treatment as derivatives that are labeled as swaps and are also traded on centralized electronic trading systems.

Clearing Systems

The Report further recommends that swaps excluded from the CEA could be cleared and could be regulated by the CFTC, another federal regulator, or a foreign financial regulator that satisfies appropriate standards. The Report suggests that the applicable regulator should depend upon the type of other contracts cleared by the clearing entity. Thus, for example, clearing organizations that clear futures generally could clear OTC derivatives subject to the oversight of the CFTC, while securities clearing agencies could clear OTC derivatives with the exception of instruments involving non-financial commodities. As to such non-financial instruments, the Report recommends that the CFTC be authorized by Congress to develop rules establishing and regulating clearing systems for these types of OTC derivatives (to the extent that they are exempted by the CFTC in a manner that allows clearing).

While we recognize that providing clearing facilities for OTC derivatives can serve a valuable function in reducing systemic risk, we agree with the Working Group that clearing systems, which involve the centralization to some extent of financial risk, should be subject to appropriate federal regulation. In general, we believe that clearing organizations that presently clear futures and options on futures also should be permitted to clear OTC derivatives. In particular, we agree with the Working Group that it is appropriate for Congress to authorize the CFTC to regulate clearing systems for OTC derivatives for non-financial commodities. In addition, though, we would argue that the rules promulgated by the CFTC for the clearing of OTC derivatives should provide regulatory parity on clearing rules as between futures contracts and OTC products.

As to financial commodities, we believe that the division of jurisdiction among federal regulators deserves further study to clarify potential differences in regulatory treatment of comparable products. We believe that Congress should review carefully whether this proposed division of jurisdiction might give rise to disparities in regulatory treatment between classes of similar financial instruments and thus could generate competitive concerns based upon such regulatory disparity.

Regulatory Relief for Exchange-Traded Derivatives

The appropriate level of regulatory burden for exchange-traded derivatives is not directly addressed in the Report. However, buried in the Report is what may be characterized as a general principle for determining this regulatory level. The Report stated that "[e]xchange trading should not be subject to regulations that do not have a public policy justification." We strongly agree with this organizing principle.

The Report recommends that Congress give the CFTC explicit statutory authority to provide appropriate regulatory relief for exchange-traded futures if deemed by the CFTC to be consistent with the public interest. We believe that such statutory authority would be useful to the extent that it clarifies that the CFTC has been given exemptive authority by Congress that is even more sweeping in scope than that contained in Section 4(c) of the CEA.

By comparison, the Report states that continuing regulation of trading activity for particular exchange-traded futures contracts is warranted depending upon the degree of: 1) accessibility to these markets by retail customers; 2) price discovery occurring in such markets; and 3) the susceptibility of such markets to market manipulation. The Report indicates that, to the extent that these factors are less relevant, "regulatory adjustments" may be necessary.

We generally agree that the extent of retail participation in a contract and its susceptibility to manipulation are relevant factors in determining the appropriate level of regulation. On the other hand, we note that, with the continuing proliferation of electronic billboards and quote dissemination systems for OTC products, OTC markets are now also providing a price discovery function for certain products, albeit a function that is different in certain respects from the function provided by regulated futures exchanges. Therefore, we question the appropriateness of this factor as a standard for determining the appropriate level of regulation for exchange-traded derivatives.

Exclusive Jurisdiction

The Report discussed eliminating the CFTC's exclusive jurisdiction of futures contracts. The Report did not make a formal recommendation in this area, and noted that the CFTC is still reviewing the consequences of this change. We believe that it is appropriate for the CFTC to weigh all of the ramifications of making such a change. However, we would suggest that consistency in regulatory treatment is advanced if one regulator is charged with sole jurisdiction for futures contracts; the CFTC has served in that role for a sufficient period as to develop real expertise with regard to such products. Therefore, we believe that the CFTC is well-positioned to offer consistency in regulatory treatment and could thus diminish the likelihood of creating further regulatory disparities and the competitive disadvantages resulting from such disparities.

Single Stock Futures

The Working Group members, while not making a formal recommendation, agreed that the current prohibitions on single stock futures can be repealed if issues about the integrity of the underlying securities market and regulatory arbitrage are resolved. We believe that these issues are resolvable, and we support such a repeal.

Summary

As a basic principle of public policy, attempts at serious and comprehensive regulatory reform should be fair and even-handed both for OTC and exchange markets. The Report, taken as the basis for a legislative reform program, falls short of meeting that standard. The Report recognizes the regulatory disparities and blurred product distinctions that unduly restrict U.S. exchanges in today's competitive global market, but does almost nothing to address those issues.

As a regulated, public futures market, we have serious concerns regarding our future ability to serve effectively and efficiently a demanding marketplace under the present regulatory regime. We urge this Committee and the Congress to provide urgently needed flexibility to exchanges to develop and provide innovative risk management products and trading methods, and to support harmonization of the regulatory structure over foreign boards of trade offering instruments with pricing impact in United States commerce. We credit this Committee and the current Chairman and commissioners at the CFTC for their willingness to wrestle with long-standing regulatory disparities, and we hope to work with the CFTC, President's Working Group and Congress to achieve comprehensive reform of the risk management markets.

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Mr. Chairman and Members of the Committee, NYMEX thanks you for your consideration and pledges its full support to work with you and your staff to address these issues and any others that may be of concern to you. Thank you very much.

TESTIMONY
of
SCOTT GORDON
CHAIRMAN OF THE BOARD OF DIRECTORS
CHICAGO MERCANTILE EXCHANGE

Before the

Committee on Agriculture, Nutrition and Forestry

United States Senate

February 10, 2000

TESTIMONY
OF
SCOTT GORDON
CHAIRMAN OF THE BOARD OF DIRECTORS
CHICAGO MERCANTILE EXCHANGE

INTRODUCTION

Chairman Lugar, members of the Committee, I am Scott Gordon, Chairman of the Board of Directors of the Chicago Mercantile Exchange (CME). The Exchange welcomes this opportunity to offer its view of the "Report" of the President's Working Group on Financial Markets. I want to begin by unequivocally expressing our support for the efforts of the CFTC, under Chairman Rainer, to reexamine and reassess the regulatory structure of our industry. The Commission's initial revisions to its thick white book of regulations demonstrates a commitment to bring regulatory burdens into line with regulatory needs. That said, and without criticism of our regulator's endorsement of the Report, it is fair to say that the CME is extremely concerned. It is clear to us that the Report's proposal unjustifiably tilts the playing field against existing exchanges.

The Chicago Mercantile Exchange, the Chicago Board of Trade and the New York Mercantile Exchange have been working for some time to change the underlying philosophy of financial service regulation. During 1999, we presented a five-part program for CFTC reauthorization. We agreed that OTC markets suffer from legal uncertainty that should be resolved by changing the Commodity Exchange Act. We supported legal certainty for privately negotiated over-the-counter transactions, sought major revisions to the Shad/Johnson Accord, and called for rationalization of regulation for the entire financial services industry.

However, we urged that any legislation should be fair and even-handed. Our goal was equivalent regulatory treatment for functionally equivalent execution facilities, clearinghouses and intermediaries. After careful assessment of the Report of the President's Working Group on Financial Markets, we are disappointed that our efforts to create a fair and level playing field have not been heeded.

While the Working Group recognizes the regulatory disparities and blurred product distinctions that handcuff U.S. futures exchanges in today's competitive global market, the Report does almost nothing to address those issues. This omission is a serious flaw. The Report calls for some changes that are in accord with our principles; however, its recommendations for regulatory relief and legal certainty will immediately benefit the over-the-counter market and enterprises that operate unregulated exchanges without timely relief for us.

The Report begins with a conservative call for legal certainty for OTC swaps. It veers from that simple principle to a radical realignment of markets and regulators by redefining a swap to include standardized, cleared, futures contracts traded on exchanges regulated by the SEC or by bank regulators. The call for legal certainty for a bilaterally negotiated contract has been converted into a demand for the exclusion from the CEA of exchange traded and cleared financial futures.

Bilateral Financial Derivatives:

The PWG's recommendation for legislative action is:

> "An exclusion from the CEA for bilateral transactions between sophisticated counterparties (other than transactions that involve non-financial commodities with finite supplies)"

The PWG minimizes the impact of its proposal, claiming: "This recommendation provides greater legal certainty and removes doubts about enforceability, making the U.S. a more attractive derivatives market." We think the proposal in its current form has far more serious jurisdictional and market fairness consequences than are described.

The exchanges do not object to an exemption from the CEA for true bilateral OTC transactions in financial instruments. We have, however, questioned the purpose of an "exclusion" rather than an exemption. The PWG recommends that excluded swap agreements may be fungible and cleared by a clearinghouse that is not regulated by the CFTC. This recommendation obviously strips the Commission of jurisdiction over instruments that are indisputably futures contracts.

The PWG's proposed exclusion overrides Shad/Johnson restrictions that now limit OTC transactions. The PWG proposes to exclude swap agreements that "reference non-exempt securities" from the CEA. We are confounded by the irreconcilable contradiction between the Working Group's conclusion that over-the-counter swaps, including equity swaps, should be excluded from the CEA while refusing to endorse revisions to the Shad/Johnson Accord for regulated markets. There is no principled reason to support unregulated, over-the-counter trading in a product while refusing to permit identical products to trade in the well regulated, price-transparent and liquid environment provided by the CME.

If equity swaps are excluded from the CFTC and the CFTC's exclusive jurisdiction is eliminated, these products could be claimed by the SEC jurisdiction. The PWG's suggestion that it is deregulating the OTC market needs to be carefully parsed. In fact it may only be stripping the CFTC of its jurisdiction over equity derivatives and paving the way for the SEC to take over the market.

Electronic Trading Systems

The PWG's recommendation for legislative action is:

> "An exclusion from the CEA for electronic trading systems for derivatives provided that the systems limit participation to sophisticated counterparties trading for their own accounts and are not used to trade contracts that involve non-financial commodities with finite supplies."

The Working Group advocates a complete exclusion for certain principal-to-principal transactions executed by means of electronic trading platforms that are indistinguishable from the trading systems used by the CME, the CBOT and NYMEX. The Working Group recommends distinct regulatory treatment of principal-to-principal exchanges and agency exchanges, but does not advance a compelling policy argument to support the distinction. In fact, all transactions at the CME and at the CBOT are also on a principal-to-principal basis. Both exchanges work directly only with their own clearing members and not with the ultimate customers of those members. There is no difference between a trade executed for the member's account and a trade executed for the account of a member's customer.

The existence of an agency relationship between a customer and its futures commission merchant is relevant to the question of the degree to which the firm that places the order, the customer's agent, ought to be regulated. It has no logical bearing on whether the exchange on which the order is executed needs to be regulated.

Moreover, it is often the case that contracts entered into by a principal on a principal exchange are immediately transferred to a customer. The PWG's proposal of distinctly different regulatory treatment for exchanges that permit intermediaries to represent customers and exchanges that require intermediaries to trade for their own accounts and then do a back-to-back transaction with the ultimate customer is not logical. It is clear that the customer of a dealer trading on a principals only exchange is inherently less advantaged than the customer of an intermediary trading on an exchange like the CME.

The PWG concludes the electronic trading systems are good for OTC derivatives without questioning whether it is logical to refer to exchange traded derivatives as if they were still over-the-counter products. The PWG recommends that most financial derivatives, including swaps on single equities, or single stock equity futures in our parlance, be excluded from the CEA if traded on an exchange that requires all trades to be on a principals only basis. The result will be that dealers and large customers will be able to trade single stock futures on an exchange so long as it is not a futures exchange regulated by the CFTC. In effect, this provision constitutes a de facto transfer of CFTC jurisdiction over exchange traded equity based derivatives to the SEC.

Treasury Amendment:

On the positive side, the Working Group's proposal will seek clarification of the Treasury Amendment to reverse the interpretation that it exempts all transactions by unsophisticated investors in foreign currency futures from the protections of the Commodity Exchange Act. We strongly support this clarification, which we believe will help to control the meteoric growth of Internet-based bucket shops that have been defrauding the American public.

The PWG's exact recommendation for legislative action is:

> "A clarification of the Treasury Amendment that clears the way for the CFTC to address the problems associated with foreign currency 'bucket shops' and excludes all other transactions in Treasury Amendment products from the CEA, unless they are conducted on an organized exchange."

That benign sounding recommendation also hides a wholesale realignment of CFTC jurisdiction and a major concession to foreign currency dealers, the bond dealers and securities dealers. The PWG, while proposing to restore the CFTC's jurisdiction over bucket shops, carves out a special exemption for derivative exchanges operated by an entity that is supervised by the SEC or bank regulators or an entity that is affiliated with such a regulated or supervised entity. This means that an affiliate of a broker-dealer that is not itself regulated by the SEC, can operate an exchange for foreign currency futures transactions outside the jurisdiction of the CFTC. The PWG's recommendation suggests a philosophy that the CFTC should be stripped of all jurisdiction over any entity that is even tangentially related to a bank or a broker-dealer. This far-reaching proposal to transfer jurisdiction to the SEC and bank regulators is not even explained.

In addition, The PWG's definition of "organized exchange" is "an exchange that is open to retail or agency transactions <u>and</u> that serves a self-regulatory function . . . ." This language permits an exchange, identical to the CME in every way except that it does not maintain a surveillance and compliance department, to trade and clear currency and government security futures without any CFTC regulation. No logical explanation is offered to support this strange position. If the PWG's recommendation were based on regulatory principle, rather than jurisdictional realignment, it would be required to approve complete deregulation of the CME's currency futures if the CME agreed not to exercise any form of self-regulation in that market.

<u>Clearing:</u>

The Report recommends that Congress "enact legislation to provide a clear basis for the regulation of clearing systems that may develop for OTC derivatives." The CME supports the concept but suggests that it be expanded to permit fair competition among clearing systems and to give market users a free choice among providers of clearing services. The Report suggests that SEC and bank regulated clearing houses be permitted to clear both the cash and derivative instruments. CFTC regulated clearinghouses would be limited to derivative contracts. This allocation of power and responsibility will preclude effective competition among clearinghouses and drive business toward those clearinghouses that are entitled to clear the largest base of products. We believe that market users – not Congress or the PWG -- should make the choice of clearing agency.

Hybrid Instruments:

The Working Group recommends, "enactment of a provision to clarify that the Shad-Johnson Accord shall not be construed to apply to hybrid instruments that have been exempted from the CEA." This proposal will permit banks to issue CD's whose value fluctuates as if the CD were a fully margined futures contract on a single stock. The CME does not oppose such instruments or their issuance by banks. It objects to banks being able to sell and trade futures contracts on single stocks while that privilege is denied to futures exchanges.

Miscellaneous:

Finally, the Working Group does not address one of our objectives for reauthorization. We proposed that access to derivatives exchanges be expanded by permitting banks and broker-dealers to deal in futures contracts without separately registering with the CFTC. We remain convinced that the legislative program we put forward is an important proposal that reflects sound public policy. We will continue to work for legislation that incorporates our proposal.

Conclusion:

Although we are frustrated with the one-sided recommendations in this Report, we will continue to support fundamental fairness in any legislation to reform the U.S. regulatory structure. Congressional leaders have demonstrated their commitment to tackling some difficult market disparities, and CFTC Chairman Rainer highlighted his support for serious reform in a recent speech to industry leaders in Chicago. We hope to work with the President's Working Group and Congress to provide that kind of comprehensive reform of the risk management markets.

The CFTC, under Chairman Rainer, has demonstrated it is prepared to move toward justified exemptions for financial products traded on our exchange. We are concerned, however, that regulated exchanges will remain at a severe competitive disadvantage unless and until parity of regulation is achieved. If the Working Group's recommendations are adopted without corresponding relief for regulated exchanges, the balance will be swung irretrievably against parity of regulation.

PREPARED STATEMENT OF

RICHARD E. GROVE

CHIEF EXECUTIVE OFFICER

INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

UNITED STATES SENATE

FEBRUARY 10, 2000

Chairman Lugar and Members of the Committee. I am Rick Grove, CEO of ISDA, the International Swaps and Derivatives Association. Before joining ISDA, I was actively engaged for many years in sales and trading of OTC derivatives and other financial products. ISDA has had the privilege of appearing before, and working with, this Committee for more than a decade, and we are pleased to be here again today.

ISDA's more than 450 members include the world's leading dealers in off-exchange principal-to-principal derivatives transactions. These transactions are typically referred to as "swaps" and their status under the Commodity Exchange Act is the focal point of the Report of the President's Working Group.

Swaps are powerful tools that enable American businesses and other end users in each of the 50 States to manage the interest rate, currency, commodity, credit and other related risks that are inherent in their activities. In this way, businesses and other users of swaps are able to lower their cost of capital, manage their credit exposures, and increase their competitiveness both here and abroad by focusing on their core areas of expertise. The United States has been a leader in the development of swaps and American businesses were among the earliest to benefit from these risk management tools.

The dramatic growth in the volume and diversity of swaps is probably the best evidence of their importance to, and acceptance by, end users. And it is no coincidence that the U.S. economy and the volume of swaps both grew dramatically during the last decade. Let me add at this point that ISDA's membership includes many of the businesses, financial institutions, government entities and other "end users" that rely on swaps to manage their financial and commodity market risks with a degree of efficiency and effectiveness that would not otherwise be possible.

The Working Group Report is the product of a great deal of effort by each of the members of the Group and their colleagues. It reflects a solid understanding of, and sensitivity to, the factors that enable the U.S. financial markets to so efficiently allocate capital and so effectively sustain economic growth. The Report embodies an unprecedented consensus among four key financial regulators that legislation should be enacted to provide legal certainty for swaps.

As you know, "legal certainty" simply means that parties (both dealers and end users) must be certain that the provisions of the swaps agreements they enter into are enforceable. Any uncertainty with respect to the enforceability of swaps creates risks not only for the parties involved, but for the financial system as a whole. For example, when unilateral actions by the CFTC in 1998 suggested that the CFTC might treat some swaps as "futures" contracts, Congressional action was required to preserve legal certainty for swaps and thus ensure continued market stability. The underlying policy considerations were not addressed by Congress in 1998, but they have now been carefully considered by the Working Group.

The Working Group concluded that financial swaps do not present public policy concerns of the sort that the CEA is intended to address and that legal certainty can therefore best be provided by an exclusion from the CEA. In one respect, ISDA believes that Congress should go further than the Working Group Report by excluding from the CEA swaps involving commodities with deep and liquid markets, such as various energy products. Indeed, the failure to do so may stifle the continued development of innovative energy risk management tools in the United States to the detriment of American businesses and other end users.

That having been said, ISDA agrees with the thrust of the Working Group's recommendations. There is a broad consensus on the merits of the issue and I cannot emphasize too strongly ISDA's belief that the time for Congressional action to provide legal certainty is now.

I would also stress that legal certainty should be provided in a manner that does not restrict financial innovation. As you know Mr. Chairman, U.S. financial institutions and U.S. technology companies are world leaders in their respective fields. From the broad perspective of our national interest, we should not compromise these leadership positions by creating or maintaining regulatory structures that discourage financial institutions from using, and benefiting from, the most efficient and innovative electronic technology available.

To summarize, ISDA hopes that the Working Group's Report will serve as the catalyst for the enactment of bipartisan legislation this year to provide legal certainty for swaps. As described more fully in our written statement, ISDA believes that this legislation should also provide appropriate regulatory relief for the futures exchanges.

Let me conclude with the promise that ISDA will remain committed to working with this Committee on a cooperative and constructive basis to ensure that the key objective of legal certainty for swaps is translated into legislative reality this year. Thank you, Mr. Chairman.

TESTIMONY
of a
COALITION
of
INVESTMENT AND COMMERCIAL BANKS
regarding
THE REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS
entitled
OVER-THE-COUNTER DERIVATIVES MARKETS AND
THE COMMODITY EXCHANGE ACT
before the
COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
UNITED STATES SENATE
FEBRUARY 10, 2000

Chairman Lugar, members of the Committee, this testimony is submitted by Edward Rosen, a partner with Cleary, Gottlieb, Steen & Hamilton, on behalf of an ad hoc coalition of investment and commercial banks (the "Coalition"). The Coalition is comprised of the following institutions:

The Chase Manhattan Bank
Citigroup Inc.
Credit Suisse First Boston Inc.
Goldman, Sachs & Co.
Merrill Lynch & Co., Inc.
Morgan Stanley Dean Witter & Co.

This Coalition is grateful for the opportunity to present the Committee with the Coalition's views regarding the report of the President's Working Group on Financial Markets (the "Working Group") entitled *Over-the-Counter Derivatives Markets and the Commodity Exchange Act* (the "Report"). The Coalition supports the recommendations set forth in the Report and urges the Committee to incorporate the Report's recommendations in legislation during this session.

I. The Coalition

The six Coalition firms are major participants in all U.S. financial markets, including the securities markets, government securities markets, foreign currency markets, futures markets and derivatives markets. These firms are in the forefront of financial product innovation and compete globally with non-U.S. financial institutions for international business in all financial markets.

These firms have established the Coalition for one purpose: to present to Congress a consensus, market-sensitive view on necessary revisions to the Commodity Exchange Act ("CEA"). As major participants in all financial and derivatives markets, and as members of nearly every major trade association affected by the CEA, this group is able to provide a singular perspective that cuts across product lines and reflects the integrated character of the global markets for these products.

The Coalition welcomes and endorses the Committee's reexamination of the CEA in light of the evolving needs of the markets and market participants, and we particularly support the Committee's interest in developing amendments to the CEA designed to remove barriers to innovation and to resolve issues of legal certainty that affect the use of over-the-counter ("OTC") derivative instruments under the CEA.

The Coalition commends the members of this Committee in particular for their leadership role in addressing these issues.

II. Overview

The Coalition applauds the success achieved by the Working Group in reaching consensus positions on the difficult issues presented by OTC derivatives in the context of the CEA. The unanimous recommendations embodied in the Report represent an extraordinary accomplishment. **The Coalition strongly endorses the Working Group's recommendations to provide greater legal certainty for OTC derivatives transactions and to remove obstacles to the development and use of clearing and electronic trading systems in the OTC derivatives markets.**

As noted below, the Coalition recommends that the Committee consider certain additional steps, **beyond** the scope of the Report, to foster legal certainty, reduce systemic risk and promote technological and financial innovation.

As background for the Committee's consideration of the Report, the Coalition would like to make several general observations:

- There is an urgent need for Congressional action during this session. The Working Group has characterized its recommendations as "necessary" and "important". We agree.
- The Working Group has presented Congress with valuable and constructive solutions to urgent problems. No solution, however, will be perfect from all perspectives. We must not allow perfection to be the enemy of that which can be achieved.
- We must not be seduced by superficial allusions to asymmetrical regulation and allow these to prevent us from accomplishing what can be accomplished. Historically, progress on legal certainty has been held hostage to other legislative objectives. This strategy can no longer be tolerated.

III. Enhancing Legal Certainty for Swaps

The Coalition strongly supports the Working Group's recommendation that bilateral swap agreements involving financial commodities between institutional counterparties be excluded from regulation under the CEA. This exclusion will enhance legal certainty and enhance the position of the United States as a major financial center.

In addition to the recommendations of the Working Group, the Coalition would support further relief for transactions involving non-financial commodities and a clarification that ***individually negotiated*** bilateral transactions, including those involving non-financial commodities, are not subject to regulation under the CEA.

IV. Electronic Trading Systems

The Coalition supports the Working Group's recommendation to exclude from regulation under the CEA electronic systems for trading financial derivatives which limit participation to institutional counterparties trading for their own accounts. This exclusion would remove a significant barrier to financial and technological innovation in the United States, eliminate legal uncertainty and improve the global competitive position of the U.S. financial sector.

Beyond the Working Group's recommendation, the Coalition would further encourage Congress to create an appropriate "light-handed" regulatory framework for those electronic trading systems that do not operate as exchanges and that would not otherwise qualify for exclusion from the CEA under the Working Group's recommendations. This new framework would create a legal basis for the future evolution of electronic trading systems, whether developed by exchanges or by other market participants. We would be happy to work with the Committee to develop such a framework.

V. Clearing Systems

The Coalition welcomes the Working Group's recommended clarification that qualifying swaps may be cleared without subjecting the underlying transaction to regulation under the CEA.

The Coalition also endorses the Working Group's recommendation that Congress provide a statutory basis for the oversight of clearing systems for OTC derivatives by the CFTC, federal bank and securities regulators and appropriate foreign financial regulators. We believe that creating an appropriate regulatory regime will encourage the development of clearing facilities for OTC derivatives in the U.S. and, in turn, contribute to the stability of the financial system. We would also view the codification of CFTC authority to oversee clearing of OTC derivatives as a positive and useful development.

VI. Treasury Amendment

The Coalition welcomes the Working Group's recommendation to clarify the intent of the Treasury Amendment by replacing the term "board of trade" with the term "organized exchange." This clarification alone will eliminate a great deal of uncertainty and forestall much of the litigation that has arisen in this area in the past.

We also support the Working Group's recommendation that Congress provide the CFTC with authority to address potential abuses of retail customers by foreign currency "bucket shops."

VII. Hybrid Instruments

In the area of hybrid instruments, the Working Group recommended that Congress clarify that the CEA's restriction on futures on non-exempt securities does not apply to hybrid instruments that would otherwise qualify for exemption from the CEA under the CFTC's current rules. The Coalition supports this recommendation. However, the Coalition urges Congress to take additional steps to codify an exemption for hybrid instruments, including those involving non-exempt securities, similar in scope to the CFTC's current exemption for hybrid instruments. We would be pleased to work with the Committee to accomplish that objective.

VIII. Single-Stock Futures; Shad-Johnson Accord

The Coalition does not believe that single-stock futures should be unlawful *per se*. The Coalition welcomes the CFTC-SEC dialogue on this subject requested by you, Mr. Chairman, and referenced in the Report, and stands ready to assist in any efforts to address the regulatory challenges posed by these products.

Congress must recognize that providing legal certainty for OTC derivative instruments and removing barriers to innovation are much more urgent matters for U.S. financial markets than creating a regulatory framework for single-stock futures. In the past, legislative efforts to provide legal certainty for OTC derivatives have been held political hostage to the single-stock futures issue. Congress should not allow this political strategy to undermine opportunities for concrete progress.

IX. Derivatives Dealers

The Coalition agrees with the Working Group's conclusion that no current need has been demonstrated to regulate OTC derivatives dealers, most of whom are already subject to direct and indirect regulatory oversight.

The Coalition notes that the Report reiterates the Working Group's earlier recommendation to expand the SEC's and CFTC's risk assessment authority with respect to broker-dealers and futures commission merchants.[1] The Coalition fully supports the goal of improved risk reporting to financial regulators.[2] The Coalition has some concerns, however, regarding the scope of the Working Group's recommendations in this area, and stands ready to engage in a dialogue on the relevant issues.

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1 See President's Working Group on Financial Markets, *Hedge Funds, Leverage and the Lessons of Long-Term Capital Management* 38-40 (April 1999)

2 Each of the Coalition's members was an active participant in the Counterparty Risk Management Policy Group, a voluntary private sector initiative recommending a broad range of measures designed to enhance private sector risk management and greater transparency, including enhanced regulatory reporting.

X. Conclusion

It is time for Congressional action to ensure legal certainty and remove the barriers to innovation posed by the CEA. The Working Group has unanimously urged the Congress to act and has provided Congress with a clear course of action. Moreover, the Working Group's recommendations have widespread support among financial market participants. We urge the Committee to take advantage of these rare conditions and move swiftly during this session to enactment of a bill incorporating the Working Group's recommendations.

Given the extraordinary consensus in the public and private sectors regarding the urgent need for legal certainty, market participants are carefully monitoring the reauthorization process for a signal that Congress will act on these important issues. As we have testified previously, and as financial market participants are acutely aware, the risks and obstacles to innovation posed by the CEA do not burden other major financial centers. If Congress continues to miss opportunities to modernize the CEA, the U.S. will jeopardize its position as the leading global financial center and the U.S. legislative and regulatory community will significantly diminish its own influence over the development of policy governing the global financial markets.

Congress must not allow less important issues to impede progress on these pressing matters.

The Coalition very much appreciates the Committee's interest in these issues and is committed to working with the Committee and other interested parties in an effort to solve these problems once and for all.

DOCUMENTS SUBMITTED FOR THE RECORD

FEBRUARY 10, 2000

STATEMENT

OF

THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

UNITED STATES SENATE

FEBRUARY 10, 2000

This statement is submitted by the International Swaps and Derivatives Association, Inc. ("ISDA") to the Committee on Agriculture, Nutrition and Forestry of the United States Senate (the "Committee") in connection with the Committee's February 10, 2000 hearings on the November 1999 Report of the President's Working Group on Financial Markets on Over-The-Counter Derivatives and the Commodity Exchange Act (the "Report").

Overview

ISDA is an international organization and its more than 450 members include most of the world's dealers in off-exchange principal-to-principal derivatives transactions (collectively "swaps transactions") that are the focal point of the Report. These dealer-members are among the principal customers of the futures exchanges that are regulated by the Commodity Futures Trading Commission (the "CFTC") under the Commodity Exchange Act (the "CEA"). In addition, ISDA's members also include many of the businesses, financial institutions, governmental entities and other end-users that rely on swaps transactions to manage efficiently and effectively the risks inherent in their core economic activities.

ISDA has consistently urged Congress to enact legislation to modernize the CEA. A modernized CEA should provide legal and regulatory certainty for all financial contracts, minimize systemic risk, encourage financial innovation and facilitate competition in the United States and abroad. Moreover, a modernized CEA should foster efficient, liquid and low cost financial transactions. Regulatory burdens that increase the cost or decrease the availability of risk management tools to businesses and other end-users should be imposed only in those cases where less burdensome means, including market discipline, have not been effective.

ISDA believes that the Report should serve as a catalyst for the enactment of bipartisan legislation in 2000 to modernize the CEA. The Report reflects an unprecedented consensus reached by the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the CFTC. Consistent with the Report, Congress should explicitly clarify that swaps transactions generally are not subject to regulation under the CEA as "futures" contracts and thus ensure that swaps transactions will continue to be enforceable in accordance with their terms. As stated in the Report, ". . . an environment of legal certainty . . . will help reduce systemic risk in the financial markets and enhance the competitiveness of the U.S. financial sector". Indeed, as the Report noted, the failure to do so ". . . would perpetuate legal uncertainty or impose unnecessary regulatory burdens and constraints upon the development of these markets in the United States".

This statement summarizes ISDA's views on certain of the key recommendations of the Report, including those related to legal certainty, electronic trading and clearing of swaps transactions; the Treasury Amendment; hybrid instruments; the regulation of swaps dealers; and netting. ISDA also supports including in the CEA modernization legislation provisions to provide comprehensive regulatory relief to the regulated futures exchanges. While a detailed consideration of exchange regulation was beyond Congress' specific mandate to the President's Working Group, there is a broad consensus that action is now required, both by Congress and the CFTC, to modernize exchange regulation. ISDA would welcome legislation that increases both the autonomy of the futures exchanges and their efficiency and cost-effectiveness. Legislation that provides legal certainty for swaps transactions and regulatory relief for the futures exchanges is urgently needed and should be enacted in 2000.

Legal Certainty for Swaps Transactions

Swaps transactions are effective tools that enable corporations, financial institutions, governments and other end users in all 50 States to manage the interest rate, currency, commodity, credit and other related risks that are inherent in their activities. Businesses and other users of swaps are thereby able to lower their cost of capital, manage their credit exposures, and increase their competitiveness both in the United States and abroad by focusing on their core areas of expertise. For example, if a business has floating-rate debt outstanding and is concerned that interest rates will rise, it can use an interest rate swap to create the same cash flow as a fixed-rate obligation. Similarly, if a business has the right to receive non-dollar revenues from a foreign-based affiliate, it can use a currency swap to hedge its exposure to fluctuating exchange rates. The United States has been a leader in the development of swaps transactions and American businesses were among the earliest to benefit from these risk management tools.

Unlike exchange-traded futures contracts, swaps transactions provide end-users with an opportunity to tailor the key economic terms of their transactions to their specific risk management needs. This almost limitless flexibility has led to the dramatic growth in the volume and diversity of swaps transactions. Thus, while the majority of swaps transactions relate to interest rates and foreign currency, there is increasing use of commodity, energy, credit, equity and other types of swaps transactions.

One of ISDA's principal goals since its inception has been to promote legal certainty for swaps transactions. For example, ISDA has sought to establish (i) clarity concerning how swaps transactions will be treated under U.S. laws and regulations and under laws in other countries throughout the world; (ii) certainty that they will be legally enforceable in accordance with their terms and not subject to avoidance; and (iii) certainty that key provisions in swaps transactions (including netting and termination provisions) will be enforceable, even in the case of the bankruptcy of one of the parties. ISDA has supported legal certainty initiatives in the U.S. and abroad. In addition, ISDA has developed master documentation templates for swaps transactions that are today used in the United States and around the world by the vast majority of swaps participants for their transactions.

A principal recommendation of the Report is that Congress enact legislation to provide legal certainty that swaps transactions will be enforceable in accordance with their terms. The importance of legal certainty cannot be overstated. Any uncertainty with respect to the enforceability of a swap transaction presents an obvious and significant source of risk to the individual parties to the transaction. As the Report emphasizes, any such uncertainty creates risks for the financial system as a whole and undermines the U.S. role as a key global financial center. More importantly, as stated in the Report, "an environment of legal certainty . . . will help to reduce systemic risk in the financial markets and enhance the competitiveness of the U.S. financial sector." Finally, any legal uncertainty limits the realization of the powerful risk management benefits that swaps transactions provide to businesses and other end-users.

The CEA has been a significant source of legal uncertainty because the CEA generally provides that off-exchange "futures" contracts are illegal, but it does not define the term "futures" contract. Thus, if a swaps contract were ever declared to be a "futures" contract, that contract would be illegal as a matter of law unless it qualified for an exclusion from the CEA under the so-called Treasury Amendment or for one of the limited administrative exemptions from the exchange-traded requirement such as the Swaps Exemption. For more than 10 years, Congress, financial regulators and others worked actively to preserve and promote legal certainty that swaps are not appropriately regulated as "futures" contracts under the CEA. These incremental measures have fostered the rapid growth of swaps transactions as an essential risk management tool but have not eliminated all uncertainty or addressed obstacles to ongoing innovations.

Concerns that the CEA may create legal uncertainty are neither academic nor speculative. In 1998, unilateral actions by the Commodity Futures Trading Commission (CFTC) suggested that the CFTC might treat certain swaps transactions as "futures". Because, as stated earlier, off-exchange futures contracts that do not qualify for an exclusion from or exemption under the CEA are illegal, this suggestion nearly shattered the settled expectations of the financial markets that United States swaps transactions were enforceable in accordance with their terms. The resulting uncertainty was particularly acute with respect to those categories of swaps transactions (such as swaps based on non-exempt securities) not eligible for the existing administrative exemptions from the exchange-traded requirement of the CEA. These concerns were sufficiently far reaching that Congress enacted a moratorium on most CFTC actions with respect to swap transactions. That legislation was an important action that served to calm concerns of the markets during this time. It is important to note that this was a temporary measure and it did not attempt to resolve issues related to the underlying causes of legal uncertainty. The legislation also directed the President's Working Group to conduct a study of the relevant issues. The Report reflects the results of that study.

In addition to its concerns that legal uncertainty poses systemic risk, the Working Group concluded that "[a] cloud of legal uncertainty has hung over [swaps transactions] in the United States in recent years, which, if not addressed, could discourage innovation and growth of these important markets and damage U.S. leadership in these arenas . . ."

Legal uncertainty creates barriers to innovation. For instance, as the Report notes "uncertainty involving OTC derivatives has hampered private sector efforts to utilize electronic trading systems that would enhance market efficiency and transparency." Financial institutions in the United States must have the opportunity to respond to market changes and customer demands without having to overcome unnecessary regulatory obstacles that do not exist elsewhere in the world.

The Working Group also concluded that there was no compelling policy justification for regulating swaps transactions under the CEA. This conclusion is consistent with the view taken by the CFTC itself in its 1989 Swap Policy Statement (which remains in effect) that swaps generally are not appropriately regulated as "futures" under the CEA. This view in turn formed the policy foundation for Congress' action in 1992 directing the CFTC to use its new exemptive authority to exempt most swaps transactions from almost all provisions of the CEA. In light of its conclusion that swaps transactions generally need not be regulated under the CEA, the Working Group recommended that Congress provide "legal certainty" by enacting a new statutory exclusion for swaps transactions, including swaps involving non-exempt securities, between sophisticated counterparties.

ISDA agrees with the Report's conclusion that there is no compelling policy justification for regulation of swaps transactions under the CEA. Participants in swaps transactions are sophisticated entities that do not require the special protections available to retail investors in exchange-traded futures contracts. Moreover, swaps transactions do not serve the price discovery functions or present the potential for the manipulation, that serve as the policy rationales for CEA regulation.

Energy and Other Derivatives

The Working Group concluded that the proposed new statutory exclusion for swaps transactions should not encompass swaps involving non-financial commodities in finite supply. The Report notes that there are special factors that make agricultural markets susceptible to pricing distortions and manipulation; that there have been efforts in the past to manipulate the prices of certain metals and that the cash markets for many non-financial commodities depend upon the futures markets for price discovery.

While most swap transactions today involve financial "commodities", Congress needs to provide comparable treatment for other types of swaps transactions where a compelling policy rationale for regulation under the CEA cannot be demonstrated. It is also worth considering the impact the definition of "non-financial commodities in finite supply" would have on new and emerging products. Again, ISDA believes new and emerging products should receive comparable legal certainty treatment where rationale for CEA regulation cannot be demonstrated.

ISDA believes that there are certain non-financial swaps transactions that prudently can be included in the legal certainty provisions enacted for swaps on financial commodities. For example, the market for energy-based derivatives (oil, gas and electricity) and the underlying products is very deep and liquid thus less susceptible to price distortion and manipulation. Increased liquidity to these markets is in large part due to deregulation of the energy markets, which has allowed the market to grow and innovate. If legal uncertainty remains, innovative risk management transactions in areas such as energy may be stifled to the detriment of U.S. businesses and other end-users For this reason, ISDA believes electronic trading systems for conducting swaps transactions in energy derivatives should also be excluded from regulation under the CEA.

ISDA also believes that while financial and other liquid swaps should be excluded from the CEA, Congress should reaffirm the applicability of the current swaps exemption for products that cannot prudently be included under the proposed new statutory exclusion. This is particularly important to assure that legal certainty exists for transactions that remain subject to exemptive authority.

Electronic Trading

ISDA agrees with the recommendation of the Report that the CEA be amended to ensure that entering into or trading of excluded swaps transactions, including energy swaps, through electronic trading systems does not provide a basis for regulation of either the transactions or the system. As noted earlier, energy swaps generally should be excluded from the CEA.

Congress and regulators should focus on the underlying activities that are conducted on electronic trading systems and not on whether one kind of technology or another is employed to carry on those activities. For example, a swaps transaction between two dealers or between a dealer and one of its institutional customers that is not now regulated under the CEA when effected by telephone should not be subject to regulation when it is conducted through the use of a more "contemporary" electronic system.

Systems that limit participation to a single dealer and its customers do not present the same public policy issues that exist for trading on organized futures exchanges. A single-dealer system where only one market maker is transacting with its customers does not pose the same risks as an exchange in which the entire market is participating. Issues of price manipulation, systemic failure and retail customer abuse are not present in systems limited to principal transactions by substantial counterparties.

Additionally, some multiple-dealer systems automate the services traditionally performed by an interdealer voice broker. Using a screen-based system to carry out the same basic activity does not fundamentally change the public policy implications of an interdealer voice brokerage, whether voice or electronic

Electronic trading is becoming an integral component of the U.S. financial markets. ISDA believes this is a positive development and shares the views expressed in the Report that "the introduction of electronic trading systems for OTC derivatives has the potential to promote efficiency and transparency, and by enhancing liquidity and enabling firms to impose more reliable controls on their traders, to reduce, risks." Technological advances have and will continue to increase the liquidity, transparency and efficiency of the financial markets. In addition, the use of electronic trading systems will promote the integrity of financial markets by providing a "real time" audit trail. Electronically enhanced execution, and the immediate and accurate electronic capture of trade data, facilitates trading and operational efficiencies connected with the execution and clearance of transactions. Moreover, increasing the efficiency of risk management and decreasing its costs will benefit the economy in general and not simply market participants.

For these reasons, Congress must ensure that the U.S. regulatory framework encourages developments in this area. The United States must continue to be competitive in the global derivatives business. If the regulatory framework is unable to accommodate and facilitate this development of electronic systems this business will most assuredly be conducted abroad. Unfortunately, as the Report itself acknowledges, this is not now the case because some have contended that the use of an electronic system to enter orders to execute transactions under some circumstances may disqualify the transactions from the Swaps Exemption even though the same transactions executed via telephone communications would be exempt. Historically, the over-the-counter markets operated through telephone conversations. Dealers dealt over the telephones directly with other dealers or indirectly through brokers. The fact that computers are replacing telephone conversations should not lead one to conclude that unregulated transactions need to be regulated.

Exclusion from the CEA of electronic systems for derivatives that are limited to sophisticated counterparties trading for their own accounts as recommended in the Report encourages development of electronic trading systems and removes uncertainty about the applicability of the current swaps exemption to the development of electronic trading systems

Clearing Systems

The Report correctly recognizes that clearing may reduce counterparty risks otherwise associated with swaps transactions and in turn can reduce systemic risk by generally reducing the possibility of loss due to default. For example, clearing entities for swaps probably will employ a variety of risk management measures including initial margin requirements, daily marking-to-market of all positions, variation margin requirements, intraday credit limits, back-up financial resources and stress testing.

As the Report also recognizes, however, current law tends to discourage the use of clearing systems since they may jeopardize the application of the current administrative exemption for certain swaps to the underlying transactions. ISDA supports the recommendations of the Report that the CEA be amended to ensure that the use of clearing systems for swap transactions will not affect the status of swap transactions under the CEA. ISDA also believes it is necessary to explicitly clarify that contracts that are cleared should not be regulated under the CEA simply because they are cleared.

ISDA also recognizes that the ability of clearing to reduce risk depends upon prudent operation. As the Report points out, ISDA understands that clearing may concentrate risk and that the risk management systems used by clearinghouses may therefore have regulatory implications. It is important to note, however, that Federal bank supervisors have managed to supervise banks' involvement in major payment systems with virtually no regulation. ISDA believes that, where oversight of clearing is appropriate, Congress should ensure that duplicative regulation or supervision does not occur among U.S. regulators and that U.S. regulators should be permitted to rely on the oversight performed by any other G-7 regulator.

The Treasury Amendment

Under the Treasury Amendment to the CEA, swaps transactions in or involving foreign currency, government securities or certain other enumerated "underlyings" are excluded from the CEA unless "such transactions involve the sale thereof for future delivery conducted on a board of trade". ISDA believes that the Treasury Amendment has worked well for more than 25 years and provides a more stable framework for legal certainty than does the current administrative exemption for certain swaps transactions. In ISDA's view, the Treasury Amendment should be retained as an integral part of a modernized CEA.

Nevertheless, a tremendous amount of litigation has arisen with respect to the Treasury Amendment. Many of these issues have now been resolved and the principal remaining issue concerns the scope of the term "board of trade". ISDA agrees with the recommendation of the Report that the Treasury Amendment be modified by Congress to substitute "organized exchange" for "board of trade". This clarification is an essential part of the legal certainty agenda. It would ensure that the Treasury Amendment would be administered in accordance with its original purpose to exclude from the CEA all transactions in the enumerated products that are not conducted on an organized futures exchange--whether or not the transactions are conducted on electronic trading facilities or are subject to clearing and settlement arrangements. As noted earlier, ISDA believes that the development of electronic trading systems and clearing facilities which provide the additional benefits of enhanced portfolio diversification, credit risk management and market access should be encouraged with respect to swaps transactions generally and this is no less true in the case of swaps transactions covered by the Treasury Amendment.

Hybrid Instruments

ISDA agrees with the Report's recommendation to provide legal certainty for hybrid instruments that reference non-exempt securities, including equity swaps or equity hybrids, by clarifying that the Shad-Johnson accord shall not be construed to apply to hybrid instruments that have been exempted from the CEA.

Hybrid instruments are important transactions classified as traditional securities or deposits. They possess features similar to commodity futures and commodity options and facilitate risk management and investment opportunity. OTC contracts based on or involving non-exempt securities allow parties to transfer the risk associated with changes in the price of an underlying security, basket of securities or securities index without transferring ownership of the securities themselves. These transactions permit institutional investors and portfolio managers the flexibility to hedge risks associated with securities markets and to invest in new and emerging financial markets. They also allow firms to diversify their exposures to credit risk thereby providing an important systemic risk management function.

Unfortunately, many market participants, including U.S. firms, have sought to enter these types of transactions in jurisdictions outside the United States where regulatory treatment of these transactions is not in doubt.

Regulation of Swaps Dealers

ISDA agrees with the Report's recommendation that no legislative action be taken with respect to regulation of non-affiliated OTC derivatives dealers. In reaching this conclusion, the Report notes that swaps dealers that are not affiliates of banks, broker-dealers or FCMs account for only a small percentage of swaps transactions and cites "the apparent effectiveness of counterparty discipline in containing the risk-taking of such . . . dealers". ISDA welcomes the decision of the Working Group not to seek regulation of swaps dealers, but believes it is important to underscore why this is the correct result from a policy point of view.

While many swaps dealers or their affiliates are regulated by, for example, banking regulators or the SEC, they are not regulated because of their swaps activities. Instead, in the case of banks for example, they are regulated because they hold taxpayer-insured funds. In short, they are regulated by reason of their institutional nature and all of their transactions--not just their derivatives transactions--are subject to supervision. In some instances, as in the case of insurance companies, this regulation occurs at the State level, but the regulatory rationale is based on ensuring that these firms remain sufficiently solvent to meet their obligations to policyholders. No compelling policy case has been put forth for governmental regulation of derivatives dealers solely because of their participation in swaps transactions. Institutional regulation has been, and should remain, the paradigm for Congressional action.

It is important to emphasize that firms entering into swap transactions are capable of assessing the credit risk of their counterparty or will rely on credit rating agencies or professional advisors. Dealers with lower credit ratings will find their proposed trades rejected by other financial market participants. This self-policing in the swaps industry has worked well to date. While some dealers have failed, those failures were not anywhere near to having systemic consequences. Those who seek to extend regulation into this area of the market should bear the burden of demonstrating the need for regulation and rationalize the costs and benefits of implementing such regulation.

Netting

ISDA, as an early leader in the advancement of netting contracts, agrees with the Report's recommendation to enact into law improvements in the netting regime for derivatives.

The April 1999 report, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management states, "the ability to terminate financial contracts upon a counterparty's insolvency enhances market stability. Such close-out netting limits losses to solvent counterparties and reduces systemic risk. It permits the solvent parties to replace terminated contracts without incurring additional market risk and thereby preserves liquidity. The ability to exercise close-out netting also will generally serve to prevent the failure of one entity from causing an even more serious market disruption."

ISDA has long advocated improvements to the United States Bankruptcy Code, the Federal Deposit Insurance Act (FDIA), and the Federal Deposit Insurance Corporation Improvement Act (FDICA). Provisions to allow cross-product netting and expansion and clarification of financial contracts eligible for netting minimize the risk of a disruption within or between financial markets upon the insolvency of a participant in those markets. ISDA believes these provisions, which were passed by the Senate in February 2000, should be enacted into law as expeditiously as possible.

ISDA notes that other jurisdictions, including the European Union, have enacted legislation to make clear that the netting of financial obligations is effective under their current bankruptcy regimes. This is not competition in laxity. To the contrary, countries with major financial centers are enacting legislation that ensures that their financial markets rest on solid legal foundations. Financial market participants will conduct business in those centers that provide that foundation. Firms will insist on legal opinions setting out the strength of these foundations. Firms will seek to avoid markets and firms in markets with weak structures. Enactment of these enhancements to the Bankruptcy Code, the FDIA and the FDICIA will help to better ensure the vitality of the United States financial markets.

Regulatory Relief for U.S. Futures Exchanges

ISDA also believes that CEA modernization legislation should include provisions to ensure that comprehensive regulatory relief will be provided to U.S. regulated futures exchanges. Indeed, ISDA's dealer-members are among the principal users of the futures exchanges.

While a detailed consideration of exchange regulation was beyond the scope of Congress's specific mandate to the President's Working Group in the context of this Report, regulatory relief for the U.S. futures exchanges is long overdue. For too long, they have operated under an outdated statute. Swift action is required to modernize regulation of the futures exchanges, increase their autonomy, efficiency and cost effectiveness. Futures exchanges in the United States, due to regulation, are at a competitive disadvantage vis-à-vis offshore exchanges. ISDA agrees with the Report's recommendation that existing regulatory structures (particularly those applicable to markets for financial futures) should be reviewed to determine whether they appropriately serve valid regulatory goals and believe appropriate regulatory relief should be provided for exchange-traded financial futures.

Conclusion

The recommendations of the report that are unanimously supported by the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the Commodity Futures Trading Commission should serve as a catalyst for Congressional action to modernize the CEA, promote legal certainty for swaps transactions and provide comprehensive regulatory relief for the futures exchanges.

ISDA wishes to specifically emphasize that implementation of the Report's recommendations achieves the important goal of reducing systemic risk in the OTC markets. Legal certainty for OTC transactions permits financial institutions the freedom to innovate and manage market risk and credit risk inherent in their activities. The development of electronic trading serves to reduce systemic risk by increasing liquidity, efficiency and transparency of the financial markets. The ability of clearing systems to develop without regulatory uncertainty may reduce systemic risk by allowing financial institution to reduce the possibility of widespread loss due to default. Finally, an improved netting regime for derivatives to allow orderly termination of financial contacts upon a counterparty's insolvency preserves market liquidity and market stability thereby preventing serious market disruption.

ISDA commends Congress for its thoughtful review of issues relating to the OTC markets and modernization of the Commodity Exchange Act, thus far. The House and Senate Agriculture Committees have been diligent in their review of the issue. Both Committees have held numerous hearings and forums designed to solicit information for the purpose of identifying solutions to the issues at hand.

ISDA recognizes that the Congress will wish to examine these issues from its own perspectives as well. To that end, ISDA and its members remain committed to working constructively with Congress, the Administration, the relevant regulatory agencies and others in the private sector to secure legislation to modernize the CEA.

Statement Submitted by Robert R. Champion
On Behalf of Champion Securities
to
Senate Agriculture, Nutrituion and Forestry Committee

February 10, 2000

Progress is precisely that which the rules and regulations did not foresee.

—Ludwig von Mises

Twice in the past (on June 10, 1998 and on May 18, 1999), I have submitted written testimony to the House Agriculture Committee on the history of my firm, Champion Securities, and the serious roadblocks to financial innovation that we have encountered as a result of the outmoded provisions of the *Commodity Exchange Act* ("CEA"). Rather than repeat all that was contained in those statements, I will summarize a few key points and conclude with my recommendations on what Congress should do to foster financial innovation and bring legal certainty to the over-the-counter derivatives market, particularly with respect to hybrid instruments.

Champion Securities was formed to develop and market a single over-the-counter derivative instrument, now called *MarketPlus*. The instrument by its nature is not amenable to exchange trading and cannot be regulated under the regulatory scheme established under the CEA without an exemption from most of its provisions. Many financial-market professionals, including some within the CFTC, believe that the instrument is simply not subject to the CEA because it is not a futures contract. Yet it can be regarded as having some of the characteristics of futures. Therefore, we have been working with the CFTC for over 10 years to obtain an exemption from the CEA.

The story of MarketPlus exposes the failures and shortcomings of current commodity law.

Overview of the MarketPlus Instrument

MarketPlus is a debt security within the meaning of Section 2(1) of the Securities Act of 1933. It is a variable-return debt obligation that pays interest at a money-market rate and that can be linked directly or inversely to the performance of one or more asset categories, as represented by a securities or commodity index. The instrument is fully paid for by the holder, who cannot be required to make additional payments to the issuer at any time. It is issued and sold subject to applicable federal and state securities laws to those permitted under those laws to purchase the instrument.

Investors can allocate all or a portion of their MarketPlus investment to the total return of an index and specify a "multiple" of that return ranging from –3.00 (short) to +3.00 (long). At a zero multiple, they earn a money-market rate of return. The combination of the interest earned on the principal and the return earned on the index exposure results in an overall return comparable to allocating funds between a money-market instrument and long or short positions in one or more asset categories.

Our obligations to holders are backed by a credit-support arrangement. We maintain asset backing of no less than 103% of those obligations. This "cover" is in the form of short-term Treasury securities, other investment-grade money-market instruments, and positions in futures contracts that mirror the aggregate of the indexed positions of the holders—all pledged to a trustee on behalf of the holders.

MarketPlus affords active investment managers greater liquidity and risk-management flexibility than switching among mutual funds by allowing them to use a touch-tone telephone (and, eventually, the Internet) to specify an exact market exposure at any hour or half hour during the trading day. When holders change their asset allocations, we hedge the net change in our aggregate liability to those holders by buying or selling futures contracts on that asset category.

The cost of using MarketPlus is competitive with mutual funds that accommodate active managers and "levels the playing field" for individual and smaller institutional investors. With MarketPlus, these investors now have an alternative designed specifically to meet their needs regardless of portfolio size. Just as the mutual fund enabled a large number of small investors who individually selected stocks to band together and have a professional select stocks on their behalf, passing on the cost savings to them, MarketPlus enables small investors who implement asset allocation and portfolio trading strategies to band together and have an institutional portfolio trader implement their aggregate decisions for them, enabling them to benefit from the issuer's expertise and cost savings.

Champion's Ten-Year History

In June 1990, after we redesigned our original concept of MarketPlus so that it would comply with the CFTC's Statutory *Interpretation Concerning Certain Hybrid Instruments* (the "Statutory Interpretation"), the CFTC staff gave us a no-action letter. The changes that the CFTC required made MarketPlus considerably more complicated and costly to use, and less attractive to tax-exempt investors. Nevertheless, at least, MarketPlus could be offered.[1]

In January 1992[2] we began the offering, in a private-placement to accredited investors (as defined in SEC Regulation D). Unfortunately, the negative tax consequences for tax-exempt investors severely restricted our market. (Most accredited investors have their holdings in tax-exempt accounts.) Since then we have sold approximately $90 million of MarketPlus to over 200 holders, almost all of whom relied upon registered investment advisors to make their allocation decisions. The maximum amount invested in MarketPlus at any one time was $23 million.

Over this ten-year period, we have successfully administered MarketPlus in accordance with all agreements, satisfied all redemption and termination requests, and executed almost 6000 hedging trades totaling in excess of $20 billion in notional value of futures contracts. Virtually all of these trades were new business for U.S. futures exchanges, business that—in the absence of MarketPlus—would have gone to mutual funds or to other investment vehicles outside of the futures markets. Significantly, from a public-policy viewpoint, MarketPlus takes active trading activity that most mutual funds do not want and redirects it to the futures exchanges where it belongs—and where it enhances the price-discovery process.

1 Interestingly, MarketPlus—in its original design (i.e., not structured to be a debt instrument)—is a legal "contract for differences" in all major financial jurisdictions outside the United States. Last year, a Bermuda-based financial services company licensed our MarketPlus technology and will be offering the instrument over the Internet this year to non-U.S. investors.

2 At that time, the product was called the *MarketMultiple Account* ("MMA").

The issuer of MarketPlus and its affiliated broker-dealer have had six routine audits by the SEC, the NASD, and the California Department of Corporations, and have not received any complaints from holders or their advisers.

To demonstrate that MarketPlus meets a market need, we asked a number of registered investment advisors who have used it to write to the CFTC. Here is what some of them said:

• The president of the *Society of Asset Allocators and Fund Timers, Inc.*, a professional trade organization with 170 members who collectively manage over $14 billion, wrote:

"MarketPlus makes the low cost and many of the benefits of modern institutional index trading technology available to the average retail investor—our customer. Many of our members believe that this innovative new financial instrument will provide them with risk management capabilities that are unavailable through mutual fund timing."

• John S. Lyons, President of J. Lyons Fund Management, wrote:

"MarketPlus has not only been an outstanding vehicle but also one that has functioned operationally without the slightest problem.... in 26 years [as an investment advisor], I do not recall seeing such a well-conceived investment product developed."

• Paul A. Merriman, President of Paul A. Merriman & Associates, an investment manager, wrote:

"Admittedly there are many products available to timers, but Champion's MarketPlus is the only one that delivers what we want—accurate pricing and intraday trading.... with Champion, you get precise results, and with [mutual funds] you get approximate results. There is no way to know in advance whether this difference will be meaningful or insignificant."

• Don M. Chance, Ph.D., CFA, Professor of Finance, wrote:

"MarketPlus is a significant financial innovation and is, I believe, in the spirit, if not the letter, of the [*Futures Trading Practices Act of 1992*]...."

In spite of the wide acceptance of MarketPlus, we are still struggling to find a regulatory solution that will permit a public offering of this innovative instrument to those for whom it was created. The variable nature of its indexing, and its linkage to a securities index—which implicates the "except for section 2(a)(1)(B)" constraint in the CFTC's CEA section 4(c) exemptive authority, have caused it to be a regulatory outcast.

The regulatory solution that we negotiated with the CFTC under Chairman Wendy Gramm, an exemption from the CEA under the Statutory Interpretation (the only exemptive avenue available to the Commission at that time), was unacceptable to Chairman Gramm's successor, Mary Schapiro. And the regulatory solution that we negotiated with Chairman Schapiro, to be regulated as an OTC futures contract, was unacceptable to Chairperson Born. The Commission under Chairperson Born offered no alternative regulatory solution. Now, under Chairman Rainer, the Commission is once again studying how MarketPlus should be regulated.

Our experience in attempting to find a way in which MarketPlus can be brought to market underscores the serious deficiencies in current law as it relates to OTC derivatives, especially hybrid instruments. At no time have we attempted to avoid regulation; we only have sought to find a regulatory solution that worked for us, the regulators, and potential MarketPlus investors.

As I will describe next, it is extremely important for Congress to realize that it is not just the big banks, brokers, and exchanges who are hurt by out-dated commodity regulations. Small firms, like mine, that are attempting to create new financial instruments for the growing individual investor market are hurt as well.

Improving the Current Regulatory Environment for Financial Innovation

The regulatory difficulties that MarketPlus has faced are solely the result of its being at the cutting edge of financial innovation in the 1990s, which involves new products that:

- Are designed to meet a growing demand from individual, as opposed to institutional, investors;
- Provide these investors with the ability to customize and change an instrument in order to fine-tune their investment strategies and risk-reward exposure;
- Allow investors to use advanced computer and communication capabilities, such as the Internet, to manage their investments and react quickly to changing market conditions; and,
- Are designed to have the lowest possible cost of ownership and use.

Because future financial innovation will occur primarily in the area of OTC derivatives, especially in new forms of hybrid instruments, current law now puts the CFTC in charge of deciding what will be allowed and who wins and who loses. This is too much power to give to a single regulator.

The following are my firm's recommendations on what is needed to improve the regulatory environment for financial innovation in the over-the-counter derivatives market, particularly with respect to hybrid instruments.

1. **Clarify, simplify, and codify "Part 34":** The requirements of the current hybrid instrument exemption, as contained in Part 34 of the *Code of Federal Regulations*, are generally well-conceived and—with clarification and modification—could satisfy Congress's intent to foster financial innovation. While we favor simply excluding all hybrid instruments from the CEA, we do have two specific recommendations that would provide greater legal certainty and correct certain shortcomings in the current exemption without excluding all hybrids from the CEA.

First, and most important, in accordance with the unanimous recommendation contained in the report by the President's Working Group on Financial Markets entitled *Over-The-Counter Derivatives Markets and the Commodity Exchange Act*, Congress should enact a provision to clarify that section 2(a)(1)(B), the "Shad-Johnson Accord," should not be construed to prevent swaps and hybrid instruments linked to securities indexes from being exempted from the CEA. We have submitted a specific proposal to staff on how to accomplish this result.

Second, the CFTC's 1998 *Over-The-Counter Derivatives Concept Release* stated that the definition of a hybrid instrument under Part 34 is "...extremely complex and difficult to understand and to apply." It is clear from this and other Commission statements in that release that the primary cause of these problems is the so-called "predominance test." We suggest that, in practice, the predominance test is an unnecessary requirement that can be eliminated. Doing so will result in an improved hybrid exemption that is easy to understand, straightforward in application, and legally certain.

The reason the predominance test can be eliminated is that Part 34's requirements that a hybrid instrument be fully paid and that the maximum loss be limited to the amount invested are, in combination, more than sufficient to ensure that an exempted hybrid instrument is more "securities-like" than "futures-like." The maximum-loss provision alone makes it unattractive to issue a highly leveraged, futures-like, instrument. With high leverage, a sudden small price decline could cause holders to lose more than their investment. The issuer either must hedge this possibility, passing the cost on in pricing the instrument, or fully disclose that there is a good chance that the issuer could suffer significant losses. Either alternative results in such an instrument being unattractive in the marketplace. Reputable experts on Part 34 agree with this view.

We urge Congress to codify such a "new and improved" Part 34 hybrid exemption.

2. **Do not impose additional suitability requirements on hybrid instruments:** Because so much attention is being focussed on swaps and "professional markets," we are concerned that a "qualified person," or "eligible participant," standard appropriate for those markets might be applied to hybrids as well, forgetting that—unlike swaps—hybrid instruments that are exempt under the current Part 34 exemption must be "initially issued or sold subject to applicable federal or state securities or banking laws to persons permitted thereunder to purchase or enter into the hybrid instrument."

It therefore is unnecessary to impose additional suitability requirements on hybrid instruments. To do so not only is unwarranted but would cripple the development of innovative hybrid instruments for the rapidly growing individual investor market.

3. **Have federal regulation preempt state regulation:** Just as states are precluded from having jurisdiction over futures contracts regulated by the CFTC, federal regulation of OTC derivatives should preempt state regulation. It is our experience that state securities regulators often are ill-equipped to evaluate a new OTC derivative or to set appropriate suitability standards. Unlike the traditional securities with which state regulators have experience, OTC derivatives often contain complex, on-going payment streams that do not yield to simple risk assessment.

When a state regulator does not understand a financial instrument, he or she simply sets a high, often inappropriate, and inflexible suitability standard based on the net worth of a potential investor. A flexible standard that takes knowledge, sophistication, and experience into consideration—as applied by brokers under the NASD Conduct Rules—would be far more appropriate. In other words, the "know your customer" standard provides adequate protection.

4. **Mandate institutional continuity:** The CFTC should be bound to a greater degree than it is under current law and practice by decisions made by previous incumbents. Under current practice, an applicant can be forced back to "square one" each time leadership changes (which can be quite frequent). This situation makes business planning and, when necessary, raising venture capital impossible, thereby stifling financial innovation.

5. **Allow a majority of CFTC commissioners to bring a matter to a vote:** Under current CFTC rules, only the chair is able to do so. Thus, as was our experience, whenever the chair did not have the votes to support her position on an issue, she simply did not allow it to be voted upon.

6. **Have only the issuer be "on the hook" if a hybrid instrument violates the CEA:** Current CEA section 4(a) is so broad that a registered investment adviser with a client owning such an instrument—and in theory the client as well—are both exposed to the harsh penalties of the CEA. This makes it difficult or impossible for an issuer faced with ambiguities in the statute to

offer an instrument in good faith and to allow the courts to decide whatever questions regulators or private litigants might wish to raise.

7. **Have an inter-agency decision-maker to resolve regulatory disputes:** A group, similar to the President's Working Group on Financial Markets, which would include senior officials of the SEC, CFTC, Treasury, and the Federal Reserve should— in cases of regulatory uncertainty—receive applications for new financial instruments and have the authority to decide how they should be regulated. No single agency should have a veto power over financial innovation in the United States.

8. **Define "futures contract":** Lastly, it is long overdue for Congress to define the concept of "futures." Until recently, such a proposal seemed unrealistic. Now, there may be a consensus that the lack of any statutory definition, coupled with the small number of incomplete, unclear, and conflicting judicial pronouncements on the definition of "futures," has created an unworkable situation that demands a legislative solution.

* * *

Drafting the complicated legislation necessary to bring U.S. commodities law into the new millennium is a daunting and challenging task. Nevertheless, it would be tragic if Congress did not seize this unique opportunity to take action. My firm, and whatever resources we can marshal, will be more than happy to suggest specific legislative language. Meanwhile, I will continue to find solace in Fund's Law:

"Governments will always do the right thing—after they have exhausted all other possibilities."

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QUESTIONS AND ANSWERS SUBMITED FOR THE RECORD

FEBRUARY 10, 2000

RESPONSES TO QUESTIONS SUBMITTED BY SENATOR PETER FITZGERALD, TO SECRETARY SUMMERS, REGARDING THE WORKING GROUP REPORT ON OTC DERIVATIVES AND THE CEA

Q1: The Report acknowledges that market convergence has substantially blurred the lines between swaps and futures and uses the term "derivative" to cover both futures and swaps. With respect to exchange-traded financial products that mirror OTC "plain vanilla" (standardized, fungible derivatives) swaps and involve institutional parties, would you support legislation that would exclude them from CFTC regulation?

A1: It is appropriate to begin with a recapitulation of the recommendations of the President's Working Group on Financial Markets (the "Working Group") report on over-the-counter ("OTC") derivatives markets and the Commodity Exchange Act ("CEA"). The Report unanimously recommended changes to the CEA to promote innovation, competition, efficiency, liquidity, and transparency in the OTC markets. This would be accomplished generally through the provision of legal certainty for OTC derivatives, the removal of impediments to innovation, the reduction of systemic risk, the protection of retail customers, and the maintenance of U.S. leadership in these developing markets.

Specifically, with respect to issues raised in the question, the Working Group stated that "... although the widespread use of innovations such as electronic trading and clearing have the potential to increase efficiency and reduce systemic risk, they could also blur the distinctions between exchange-traded and OTC instruments." The Working Group recommended an exclusion from the CEA for swap agreements based on financial and certain other commodities for which there is not a finite supply, that are entered into between eligible swap participants on a principal-to-principal basis and that are not traded on a multilateral transaction execution facility ("MTEF"). It also recommended an exclusion from the CEA for electronic trading systems that restrict participation to eligible swap participants trading swap agreements in financial and certain other commodities on a principal-to-principal basis.

The Working Group acknowledged in the Report that exchange-traded futures contracts with some economic characteristics similar to some of the OTC derivatives for which exclusion is recommended would face different levels or forms of regulation. The Report found that to the extent that particular exchange-traded futures markets are accessible to retail customers, serve a price discovery function, or may be susceptible to manipulation, some regulation of these markets may be warranted. To the extent that these factors are less relevant to particular markets or instruments, regulatory adjustments may be necessary, and existing regulatory structures should be reviewed to determine whether they are tailored appropriately to serve valid regulatory goals. The Working Group concluded that exchange trading should not be subject to regulations that do not have a public policy justification. The CFTC currently is examining the CEA to determine the extent to which modifications may be necessary. The report also noted that any regulatory differences would be mitigated because futures exchanges could establish excluded electronic trading systems and regulated clearing systems.

Q2: The Report sets forth the public policies that should be the focus of whether and how OTC derivative instruments should be regulated. According to the Report, these policies are to "promote innovation, competition, efficiency, and transparency in OTC derivatives markets, to reduce systemic risk, and to allow the United States to maintain leadership in these rapidly expanding markets." Based on these policies, if the exchange markets barred trading by retail customers and limited participation to sophisticated institutional investors, shouldn't they be eligible for exclusion from the CEA under the framework of the Working Group's recommendations?

A2: The exclusions recommended by the Report would be available to existing exchanges on the same terms that they would be available to any other entity. Thus, an existing exchange could establish an excluded electronic trading system if it limited participation to eligible swap participants trading swap agreements in financial and certain other commodities on a principal-to-principal basis.

Q3: Doesn't the exclusion operate to deny retail customers access to the most liquid markets? Doesn't the exclusion encourage the creation of markets with pools of liquidity that are only available to institutional participants? What is the policy behind setting up a regime that segregates the retail customer from the best markets?

A3: The objective of the recommendation to exclude from the CEA certain transactions between eligible swap participants was to permit the development of efficient, liquid, transparent, and innovative markets while still providing customer protection for less sophisticated participants. It is not anticipated that this recommendation would segregate liquidity. Market participants generally prefer markets that are more liquid, and the exclusion should not affect this preference.

Q4: The Report's recommendation to exclude OTC derivatives eliminates credit considerations, as well as the standardization and fungibility requirements in the current Swaps Exemption. However, by allowing these instruments to be standardized and fungible, OTC derivatives may take on the characteristics of exchange-traded derivatives. The current Swaps Exemption, as set forth in Part 35 of the CFTC regulations, does not allow OTC derivatives to be standardized and fungible. Did the Working Group adopt a legal test for distinguishing a swap from a futures contract? If so, what was it?

A4: The Working Group did not adopt a legal test to distinguish a swap from a futures contract. Rather, the Working Group concluded that an appraisal of the extent to which specific regulatory structures are tailored to serve valid public policy goals is a more useful guide to regulatory reform. The Working Group recommended elimination of the Swap Exemption requirements of non-standardization, non-fungibility, and material creditworthiness considerations for swaps in financial and certain other commodities between eligible swap participants on a principal-to-principal basis for two reasons: (1) to permit electronic execution of trades, thereby enhancing efficiency and transparency; and (2) to reduce systemic risk by removing legal impediments to the development of regulated clearing systems for such swaps that could reduce risk by preventing the failure of a single market participant from having a disproportionate effect on other participants and the overall market.

The Working Group acknowledged in the Report that the elimination of those requirements could create differences in the level of regulation between OTC derivatives that are electronically traded and cleared and products offered by futures exchanges that may have some similar characteristics. The differences would be mitigated because futures exchanges could establish excluded electronic trading systems and regulated clearing systems. However, to the extent that particular exchange-traded futures markets are accessible to retail customers, serve a price discovery function, or may be susceptible to manipulation, some regulation of these markets may be warranted. The CFTC currently is examining the CEA to determine the extent to which modifications are necessary.

Q5: The Working Group Report seems to adopt a distinction between execution facilities available only to sophisticated institutions and execution facilities available also to retail investors. If the agents or brokerage firms for the retail investors are regulated, does the execution facility where the broker will place the trade need any regulation?

A5: The Working Group Report made a distinction between types of customers, i.e., eligible swap participants and relatively less sophisticated retail customers, since retail customers necessitate a higher level of protection from unfair practices, as they may be less knowledgeable and less able to pursue a private right of action. With respect to execution facilities, the Working Group recommended an exclusion from the CEA for electronic trading systems that restrict participation to eligible swap participants trading swap agreements in financial and certain other commodities on a principal-to-principal basis. Thus, the Report also recommended limiting the exclusion for electronic trading systems to systems open only to eligible swap participants trading for their own account. The Report found that this limitation would provide added assurance of the sophistication of the parties transacting on the system, because systems subject to this limitation would tend to be used only by dealers or regular market participants who meet the "eligible swap participant" criteria. The Report also found that the absence of agency transactions would inhibit potential market abuses such as front-running that might otherwise arise.

The Report did not address the extent to which regulation of agents or brokerage firms that place orders for investors on an execution system may serve to lessen the need for regulation of the system itself, although it did conclude that a complete exclusion of a system where transactions can occur through agents is not warranted. The appropriate balance between regulation of futures exchanges and regulation of agents that place orders on such exchanges is best addressed by the CFTC and Congress in an examination of futures market regulation.

Q6: In a computerized world, price discovery occurs in a much different way than in the days of chalkboards and telegraphs when the CEA originated. What level of price discovery is needed before a market should be subject to the CEA today?

A6: The Report recommended an exclusion from the CEA for swap agreements in financial and certain other commodities. This recommendation was based, in part, on a conclusion that swap agreements in these commodities are not used widely as the basis for pricing other transactions or for determining prices in underlying cash markets in the same manner, for example, that agricultural futures serve as a reference for pricing cash market transactions.

The Working Group noted, however, that the enactment of a limited regulatory regime aimed at enhancing market transparency and efficiency may become necessary under certain circumstances if, as electronic trading systems develop and grow, these systems come to serve a price discovery function. It also concluded, however, that such systems, which have only just begun to emerge on a widespread basis, should not be burdened at this time by a new anticipatory statutory structure that could prove entirely inappropriate to their eventual evolution.

Q7: Would a multi-tiered system of market regulation detrimentally fragment the efficiency and transparency of the overall markets?

A7: The objective of the recommendation to exclude from the CEA certain transactions between eligible swap participants was to permit the development of efficient, liquid, transparent, and innovative markets while still providing customer protection for less sophisticated retail participants. As noted above, the Report acknowledged that different markets would be subject to different levels or forms of regulation depending on the types of participants and instruments traded. It is not anticipated that this recommendation would fragment efficiency and transparency. Market participants generally prefer markets that are more liquid. The level of regulation should not affect this preference. Moreover, the CFTC currently is reviewing the CEA to determine the extent to which modifications may be necessary, so that the Act and the regulations promulgated thereunder are not inappropriately burdensome to futures exchanges.

Q8: It seems that much of the Working Group's recommendations are about excluding products from CFTC jurisdiction. If all these products are excluded, what products would be left that would be subject to the CEA? If the lines now are blurred between exchange-traded and OTC derivatives products, why should only exchange products be regulated by the CFTC?

A8: The Working Group recommended an exclusion from the CEA for swap agreements in financial and certain other commodities that are entered into between eligible swap participants on a principal-to-principal basis and that are not traded on an MTEF. Thus, the exclusion does not extend to products and markets that: (1) are non-financial products that have finite supplies that render them susceptible to supply and pricing distortions and price manipulation; (2) permit access by participants that do not qualify as eligible swap participants; or (3) permit trading that is not conducted on a principal-to-principal basis. Therefore, such products will continue to be subject to the CEA and traded on exchanges unless otherwise exempted by the CFTC. Some level of regulation of such products to serve public policy goals is warranted when the market is accessible to retail customers, serves a price discovery function, or may be susceptible to manipulation.

Q9: If equity swaps are excluded from the CEA, which federal agency will oversee these increasingly popular products?

A9: The Working Group report does not contemplate the development of a novel regulatory structure for instruments that it recommends for exclusion from the CEA, in part because the instruments may only be entered into by eligible swap participants trading for their own account to qualify for the exclusion. Thus, the extent to which regulators other than the CFTC may have a role

Q12: Does the Report recommend the elimination of the exclusive jurisdiction of the CFTC over contracts of sale for future delivery?

A12: No. Several members of the Working Group believe that the exclusive jurisdiction clause of the CEA should be modified so that it would be clear that it applied only to transactions in futures and commodity options contracts effected on designated contract markets. However, the Report contains a unanimous recommendation for a more limited modification of the exclusive jurisdiction clause to provide that insofar as hybrid instruments may be subject to the CEA, the exclusive jurisdiction clause shall not be construed to limit the authority of the Securities and Exchange Commission or the bank regulators with respect to such instruments.

Q13: How does the Report define "nonfinancial commodities with finite supplies?" Does that term, for example, include energy derivatives?

A13: The term "nonfinancial commodity with a finite supply" would include energy products such as crude oil, heating oil, gasoline, fuel oil, jet fuel, natural gas, liquefied propane gas, and electricity. The Working Group recommended that the CFTC should retain and exercise its current authority to grant exemptions for derivatives involving such non-financial commodities where appropriate, as it has done for certain energy derivatives products.

The term would not include index products such as weather derivatives (i.e. heating/cooling degree day indexes), since they do not have a finite supply. Such derivatives would be excluded from the CEA to the same extent that derivatives on financial commodities would be under the Working Group's proposals.

Q14: Doesn't the Report encourage the wholesale migration of financial derivatives to a less regulated environment? If this occurs, what would be the impact on traditional agricultural products traded on the exchanges? Would those markets be less liquid and more volatile than they are today?

A14: As stated above, it is not anticipated that the recommendation excluding from the CEA certain financial and other transactions conducted by specific participants would encourage widespread migration of financial derivatives to a less-regulated environment. Market participants generally prefer markets that are more liquid. The level of regulation should not affect this preference. Moreover, the CFTC currently is reviewing the CEA to determine the extent to which modifications may be necessary, so that the Act and the regulations promulgated thereunder are not inappropriately burdensome to futures exchanges.

The Report did not recommend the exclusion of any transactions in the §1a(3) traditional agricultural commodities. The exclusion would only apply to swap agreements in financial and certain other commodities for which there is not a finite supply that are entered into between eligible swap participants on a principal-to-principal basis and that are not traded on an MTEF or that are traded on an excluded electronic trading system.

Q15: The Report recommends that only principal trades be eligible for exclusion from the CEA and frequently refers to markets where "principals are trading for their own accounts." In recommending that only principal trades be eligible for exclusion from the CEA, doesn't the Report also permit a centralized electronic "dealers only" market for trading derivatives? Under the Report, couldn't a dealer's back office trade directly with its institutional customers at prices based upon, and reflecting a markup of, the centralized "dealers only" market price and still qualify for exclusion? What is the policy behind encouraging the creation of markets that are not directly accessible to many market participants?

A15: The recommended exclusion would permit centralized electronic trading systems that restrict participation to eligible swap participants trading swap agreements in financial and certain other commodities only if the transactions are conducted on a principal-to-principal basis. As discussed above, the Working Group concluded that limiting the availability of the exclusion for electronic systems in this manner would provide added assurance of the sophistication of parties eligible to trade on the system and help to limit potential abuses that arise when parties may trade through agents. The Working Group also concluded that a limited exclusion was more appropriate than the development of a new anticipatory statutory structure that could prove entirely inappropriate to the eventual evolution of such systems. The exclusion would not be limited, however, to "dealer only" systems.

It was not the intent of the Report to encourage the creation of markets that are not directly accessible to many market participants. The Report's recommendations are based on the likelihood that new ETSs for OTC derivatives will at least initially limit participation to entities that meet the definition of "eligible swap participant." The Working Group wished to avoid hindrance of the development of these markets that would be caused by the creation of a regulatory structure under the CEA that could be inappropriate to their potential evolution. If such ETSs eventually decide to permit retail participation or if the market prices for transactions executed through an excluded system become widely used as the basis for pricing other transactions, some form of regulation may become appropriate.

Q16: The Report states that one of the conditions required to be met for exclusion of a bilateral swap agreement is that the transaction not be conducted on a MTEF as the term is used in the current Swap Exemption in Part 35 of the CFTC's regulations. How does the CFTC interpret and apply this standard?

A16: The CFTC has explained that an MTEF "is a physical or electronic facility in which all market makers and other participants have the ability to execute transactions and bind both parties by accepting offers which are made by one member and open to all members of the facility." Exemption for Certain Swap Agreements, 58 Fed. Reg. 5587, 5581 (Jan. 22, 1993) (the "Swap Exemption Release"). The CFTC's statements about the interpretation and application of this standard are set forth in the Swap Exemption Release. Additional statements by the CFTC concerning the treatment of swaps are found in its Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694 (July 21, 1989).

Q17: How does the CFTC define "transaction execution facility" and what is the CFTC's position on the meaning of "multilateral" in the context of the current Swaps Exemption?

A17: Please see the response to question 16.

Q18: Would an electronic system that allows many swap dealers simultaneously to view, react to, and execute against bids and offers for swap transactions be covered under the definition of MTEF as stated in the current Swaps Exemption?

A18: Please see the answer to question 16. If the Report's recommendations were enacted, any form of electronic trading system that met the product and participant criteria and permitted only transactions conducted on a principal-to-principal basis would qualify for exclusion from the CEA.

Q19: The Report would exclude from regulation under the CEA a standardized, fungible derivative traded on a principal basis among institutions if the trading occurs on a multilateral electronic or computerized trading facility. However, if that same derivative contract is traded on the same basis by the same institutions in a pit trading environment, the trading activity would be subject to full scale regulation by the CFTC. What is the basis for this disparity? What is the public policy rationale for treating electronic trading systems operated by the OTC derivatives industry differently than electronic trading systems operated by futures exchanges?

A19: The Report recommended an exclusion from the CEA for swap agreements in financial and certain other commodities that are entered into between eligible swap participants on a principal-to-principal basis and that are not traded on an MTEF. It also recommended an exclusion from the CEA for electronic trading systems that restrict participation to eligible swap participants trading swap agreements in financial and certain other commodities on a principal-to-principal basis. Existing exchanges would be able to offer trading systems that qualify for the exclusion and compete with any new systems. Thus, no disparity would exist. The Report did not discuss whether pit trading should be excluded from the CEA if conducted among eligible swap participants on a principal-to-principal basis, because it is not clear that demand for such a trading venue would exist. The Working Group would be willing to study and consider the appropriate level of regulation or exclusion if demand for such a venue should develop.

Q20: Historically, the CFTC has regulated derivatives clearing in the United States because of its expertise in that area. The Report expands that oversight authority to other federal agencies. What is the public policy for expanding CFTC's authority to other federal agencies?

A20: The CFTC historically has regulated the clearing of on-exchange futures contracts and options thereon based not on any explicit statutory authority, but instead through extension of its authority to review exchange rules and rule changes. Under current law, there are uncertainty and legal issues that arise under the CEA, and it is not clear that the CFTC has the authority to oversee clearing systems for OTC derivatives. The Working Group recommendation was intended to remove this uncertainty in order to enhance efficiency and stability. The Working Group felt that, although a clearing system can reduce systemic risk, it should be subject to regulatory oversight to ensure that proper risk management procedures are established and implemented and that the system is properly structured.

The Report recommended that: (1) clearing organizations that clear futures and commodity options also should be authorized to clear transactions in excluded OTC derivatives (other than OTC derivatives that are securities, such as security options), subject to CFTC oversight; (2) securities clearing agencies already subject to SEC oversight also should be authorized to clear excluded OTC derivatives (except products listed on CFTC-designated contract markets); (3) the CFTC should be authorized to develop rules for clearing systems for OTC derivatives on non-financial products with finite supplies; (4) other clearing systems organized as a bank, bank subsidiary, or affiliate, or Edge Act corporation should be subject to supervision by a banking regulator; (5) a clearing system that is already subject to regulation by one agency should not become subject to regulation by another agency solely because it clears OTC derivatives; and (6) clearing through foreign clearing systems should be permitted if they are supervised by a foreign regulator that a U.S. regulator has determined satisfies appropriate standards. Thus, it was recommended that other regulators should continue to have jurisdiction over entities/clearing systems for which they currently have authority, thereby eliminating duplicative regulation.

Q21: The Report recommends that clearing be permitted through foreign clearing systems that are supervised by a foreign regulator that "the appropriate U.S. regulator has determined satisfies appropriate standards." What is meant by "appropriate U.S. regulator" and "appropriate standards?"

A21: The terms "appropriate U.S. regulator" and "appropriate standards" were not defined in the Report. "Appropriate U.S. regulator" generally is construed to mean the U.S. counterpart of a foreign regulatory body. In this context it would mean the CFTC, the SEC, the Board of Governors of the Federal Reserve System, or the Comptroller of the Currency. The exact meaning of "appropriate standards" would be determined by the regulator, but would generally be interpreted to mean standards comparable to those imposed on U.S. clearing systems by U.S. regulators.

Q22: In connection with a recommendation to change the language of the Treasury Amendment, the Report adopts a definition of "organized exchange" that has two parts: (1) it permits retail or agency trades and (2) it provides for self-regulation. What is meant by the term "retail or agency trades?" To be excluded from the definition of an "organized exchange," must the trades be for sophisticated parties and/or those that meet some asset test? Do agency trades have to be for non-sophisticated retail customers to be considered on an "organized exchange?"

A22: The intent of the recommendations regarding the Treasury Amendment was to clarify the scope of the Amendment's exclusion and the types of trading that can occur outside of CEA purview, while providing explicit and enhanced protection for retail customers.

The Treasury Amendment specifies that "[n]othing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency ... [or] government securities *unless* such transactions involve the sale thereof for future delivery conducted on a board of trade" [emphasis added]. The latter portion of the clause is known as the "unless clause." Because the meaning of the term "board of trade" has been the subject of litigation, the Working Group recommended clarification of the "unless clause" while providing enhanced and explicit protection for retail customers to foreign currency futures and options transactions marketed by entities other than regulated banks and broker-dealers and their affiliates. The recommendation reflected the general characteristics of an "organized exchange": an MTEF that is open to retail or agency transactions and that regulates its members. However, the Report language was not intended to provide a comprehensive statutory definition of this term.

A "retail trade" generally is understood to mean a trade in which one or both of the parties is not an entity listed in the definition of an "eligible swap participant" in Part 35 of the CFTC's regulations. It should be noted, however, that the Report recommended further limiting the extent to which natural persons are covered by this definition by using a threshold of discretionary investments of not less than $25 million. An "agency trade" would mean a trade that is executed through an agent, i.e. not on a principal-to-principal basis. Any agency trades, whether for sophisticated or non-sophisticated, retail or institutional customers, would be covered by the term. The report described an "organized exchange" that would be subject to the CEA under the Amendment as "an exchange that is open to retail or agency transactions and that serves a self-regulatory function."

Q23: Under the Report's proposed change to the Treasury Amendment, could an exchange which is open to retail customers and which trades Treasury Amendment products other than foreign currencies opt out of the CEA simply by dropping its self-regulatory organization functions? If so, wouldn't that result lead to a form of regulatory arbitrage?

A23: The intent of the Report's recommendations was to clarify the scope of the Treasury Amendment. The Report contained recommendations based on the general characteristics of an "organized exchange"; however, the Report language was not intended to conclusively define such legal terms. The Working Group would be willing to assist in drafting language to clarify any ambiguity. In any case, transactions in Treasury Amendment products that are similar to existing government securities futures would be subject to U.S. securities laws if they are not subject to the CEA and shielded from such laws by the CEA's exclusive jurisdiction provision.

Q24: If the Chicago Mercantile Exchange disbanded its self-regulatory operations, could it offer its foreign currency contracts and avoid being regulated as an "organized exchange?"

A24: The Report recommended enhancing the CFTC's authority over foreign currency transactions by providing that foreign exchange futures and options would be subject to the CEA if they are entered into between a retail customer and an entity that is neither regulated or supervised by the SEC or a federal banking regulator nor affiliated with such a regulated or supervised entity. If the CME permitted trading in such contracts by retail participants, the retail transactions would be subject to the CEA and would have to be traded on a CFTC-designated contract market.

Q25: If the Chicago Board of Trade continued its self-regulation, but told its members that no agency trades would be allowed on its exchange, would the Board of Trade be considered an "organized exchange?"

A25: If the CBT continued its SRO function but allowed neither retail nor agency trades, it would not be considered an "organized exchange" for purposes of the Treasury Amendment. However, as noted above in response 23, its futures contracts on government securities would then be subject to the securities laws. The CBT and its non-Treasury Amendment products would continue to be regulated by the CFTC.

Q26: With respect to the Report's recommendation on changing the language of the Treasury Amendment, (a) Why should a system that agrees to self-regulate face government regulation while a system that avoids self-regulation face no government regulation?; (b) What public policy is served by permitting U.S. futures exchanges to trade foreign currency or government security futures without any CFTC regulation if they eliminate their self-regulatory function?; (c) What public interest is served by having government regulate the self-regulating entity but not the entity in the same business that does no self-regulation?; and (d) What public interest is served by permitting a system that allows agency trades for customers only outside the ambit of self-regulation to be excluded from regulation?

A26: Congress has concluded in the context of both the securities laws and the CEA that entities that serve a self-regulatory function must themselves be regulated. This is the case because an entity such as an exchange or industry association that asserts the authority to govern the business activities of its members through rules of conduct and disciplinary proceedings is performing a quasi-governmental function that readily can be abused. Accordingly, governmental oversight by federal regulatory agencies that are ultimately accountable to Congress has been deemed necessary. The Working Group's proposed changes to the Treasury Amendment do not alter this principle.

As noted above in responses 23 and 25, transactions in government securities that are excluded from the CEA by the Treasury Amendment would be subject to the securities laws.

The wholesale foreign currency market traditionally has been unregulated, although many major participants are regulated entities. Banks often act as agents for their institutional customers in this market, where there is no self-regulatory organization for foreign currency trading that does not occur on an organized exchange. Among the reasons that the Working Group did not propose an effort to subject this market to regulation were the global nature of this market and the practical difficulties of regulating a market that by its very nature involves foreign jurisdictions.

Q27: What is the public policy rationale for excluding Treasury Amendment products from the provisions of the CEA unless those products are traded on a futures exchange?

A27: With respect to the Treasury Amendment exclusion, the Report stated that "[t]here are several rationales for this exclusion from the CEA. These markets serve important macroeconomic functions that are best served by minimal regulation. The main participants in the foreign currency markets are largely sophisticated institutions, such as commercial and investment banks, central banks, foreign exchange dealers, corporations, and pension and mutual funds, that are well informed and do not need protection. The market is highly efficient and has served the needs of the international business community well. Similarly, the government securities market is one of the most efficient markets in the world and has served the Treasury and the taxpayers well. Moreover, since 1986, government securities have been regulated under the Government Securities Act, and government securities transactions are subject to the anti-fraud and anti-manipulation provisions of the federal securities laws.[11]

international business community well. Similarly, the government securities market is one of the most efficient markets in the world and has served the Treasury and the taxpayers well. Moreover, since 1986, government securities have been regulated under the Government Securities Act, and government securities transactions are subject to the anti-fraud and anti-manipulation provisions of the federal securities laws.[11]

Questions submitted by Senator Peter Fitzgerald to Chairman Alan Greenspan
For the Hearing on the
President's Working Group Report on OTC Derivatives

Q.1. The Report acknowledges that market convergence has substantially blurred the lines between swaps and futures and uses the term "derivative" to cover both futures and swaps. With respect to exchange-traded financial products that mirror OTC "plain vanilla" (standardized, fungible derivative) swaps and involve institutional parties, would you support legislation that would exclude them from CFTC regulation?

A. 1. The fact that the OTC markets function quite effectively without the benefits of the CEA provides a strong argument for development of a less burdensome regime for exchange-traded financial derivatives. The CFTC's recently released study on alternative regulatory frameworks indicates its intention to pursue such a less burdensome regime, to the extent possible within its current authority. That effort should be supported, as well as the passage of any additional legislation necessary to develop a more appropriate regulatory regime for exchange-traded products that are not easily manipulated and are not marketed to the retail public.

Q.2. The Report sets forth the public policies that should be the focus on whether and how OTC derivatives instruments should be regulated. According to the Report, these policies are to "promote innovation, competition, efficiency, and transparency in OTC derivatives markets, to reduce systematic risk, and to allow the United States to maintain leadership in these rapidly expanding markets." Based on these policies, if the exchange markets barred trading by retail customers and limited participation to sophisticated institutional investors, shouldn't they be eligible for exclusion from the Commodity Exchange Act ("CEA") under the framework of the Working Group's recommendations?

A.2. The Working Group focused on OTC derivatives rather than exchange-traded instruments. However, the Working Group recognized that enactment of its recommendations would create regulatory disparities between some OTC derivatives that are electronically traded and cleared and exchange-traded futures contracts. To mitigate this regulatory disparity, the current CFTC efforts to develop a less burdensome regulatory regime for exchange-traded products should be supported. In some areas, legislation may be necessary to give the CFTC explicit authority to provide that relief. In addition, the Working Group recommended that electronic trading systems that limit participation to eligible swap participants trading for their own account and that do not list contracts involving a nonfinancial commodity with a finite supply should be excluded. Furthermore, the Working Group recommended that exchanges that have been designated as contract markets by the CFTC should be permitted to establish such excluded electronic trading systems. This recommendation is somewhat narrower than the exclusion suggested in the question. In particular, the exclusion is limited to contracts based upon commodities that are not easily manipulated.

Q.3. Doesn't the exclusion operate to deny retail customers access to the most liquid markets? Doesn't the exclusion encourage the creation of markets with pools of liquidity that are only available to institutional participants? What is the policy behind setting up a regime that segregates the retail customer from the best markets?

A.3. The goal of the Working Group's recommendations is to align regulatory structures to public policy objectives. Those public policy objectives may differ for retail and institutional customers. The customer protection regime appropriate for most retail customers would be unnecessarily burdensome and costly for institutional customers. For the vast majority of instruments covered by the Working Group's recommendations, retail participation is minimal, and questions of segregation of activity do not arise. However, in those instances where there is retail participation and separate markets coexist, they would nonetheless be linked by arbitrage.

Q.4. The Report's recommendation to exclude OTC derivatives eliminates credit considerations, as well as the standardization and fungibility requirements in the current Swaps Exemption. However, by allowing these instruments to be standardized and fungible, OTC derivatives may take on the characteristics of exchange-traded derivatives. The current Swaps Exemption, as set forth in Part 35 of the CFTC Regulations, does not allow OTC derivatives to be standardized and fungible. Did the Working Group adopt a legal test for distinguishing a swap from a futures contract? If so, what was it?

A.4. No, the Working Group did not specify a legal test for distinguishing a swap from a futures contract. Rather, the Working Group examined the public policy objectives of the CEA (prevention of price manipulation and protection of retail investors) and evaluated whether those objectives were appropriately applied in the swaps market. The Working Group concluded that they were not because of the nature of swap counterparties (they are sophisticated) and because of the nature of the contracts (the vast majority are cash settled and based upon rates or prices established in highly liquid markets so they are not susceptible to manipulation). These characteristics of swaps, and thus the conclusion about the appropriateness of applying the CEA, do not depend upon standardization, fungibility, or credit considerations.

Q.5. The Working Group report seems to adopt a distinction between execution facilities available only to sophisticated institutions and execution facilities available also to retail investors. If the agents or brokerage firms for the retail investors are regulated, does the execution facility where the broker will place the trade need any regulation?

A.5. It is not clear that such execution facilities need the level of regulation currently provided in the CEA. The CFTC recognized this distinction in its recently released staff proposal for a new regulatory framework. Its proposal for derivatives transaction facilities envisions a lightly regulated facility in which non-institutional traders have access only through a CFTC-regulated intermediary.

Q.6. In a computerized world, price discovery occurs in a much different way than in the days of chalkboards and telegraphs when the CEA originated. What level of price discovery is needed before a market should be subjected to the CEA today?

A.6. It is not at all clear that the fact that a market serves a price discovery function is, by itself, a justification for subjecting it to the CEA. Rather, if a market is readily susceptible to manipulation, the fact that it serves a price discovery function means that price fluctuations from attempts at manipulation may have significant adverse effects on the pricing of other transactions. However, if a market is not readily susceptible to manipulation, it is not clear that it should be subject to the CEA, even if it serves a price discovery function. In any event, regulation under the CEA seems unnecessary if buyers and sellers of the commodity have other reliable sources of information on the commodity's price and thus are not dependent upon the market for price discovery.

Q.7. Would a multi-tiered system of market regulation detrimentally fragment the efficiency and transparency of the overall markets?

A.7. A multi-tiered system of market regulation would not detrimentally fragment the efficiency and transparency of the overall markets. Arbitrage between the market segments that may appear to be fragmented should ensure that the overall markets will operate efficiently and transparently. Indeed, the current single-tiered system of regulation detrimentally affects the efficiency of the overall markets because institutional market participants are compelled to bear the added costs of the rules designed for retail market participants. Retail participation in many such markets is minimal, suggesting that such rules do not serve purposes commensurate with their costs.

Q.8. It seems that much of the Working Group's recommendations are about excluding products from CFTC jurisdiction. If all these products are excluded, what products would be left that would be subject to the CEA? If the lines now are blurred between exchange-traded and OTC derivative products, why should only exchange products be regulated by the CFTC?

A.8. Transactions should be subject to the CEA only if they are susceptible to manipulation or fraud. To the extent that contracts are not readily susceptible to manipulation and market participants are capable of protecting themselves against fraud, they should not be regulated by the CFTC, even if traded on exchanges. (It may be appropriate to require regulated and unregulated products to be listed on separate exchanges.) The Working Group's recommendations focus on excluding transactions from the CEA because the act's broad definitions of commodity and future can be construed to cover virtually any financial transaction.

Q.9. If equity swaps are excluded from the CEA, which federal agency will oversee these increasingly popular products?

A.9. The Report suggests that if equity swaps are excluded from the CEA, the SEC would be the appropriate agency to serve as the principal authority for regulating transactions calling for the delivery of equity securities. The Working Group unanimously recommends that the CFTC and the SEC work together and with Congress to determine whether single-stock futures should be permitted and if so, under what conditions.

Q.10. In the past, the OTC derivatives industry has effectively argued that its derivatives trading was bilateral, customized and non-fungible. Now the Report suggests that OTC derivatives trading can be multilateral, standardized, fungible, and cleared. If that is the case, what is the functional difference between a financial exchange derivative and an OTC derivative?

A.10. These "functional differences" between a financial exchange derivative and an OTC financial derivative are largely irrelevant to the purposes of the CEA--deterring manipulation and fraud. The Working Group's Report largely eschews such irrelevant differences and draws distinctions largely on the basis of whether the underlying commodities are susceptible to manipulation and whether the market participants need additional protection from fraud through a system of federal regulation.

Q.11. Is it the intent of the Report to relegate the CFTC to the oversight only of the United States futures exchanges?

A.11. The Report recommends that Congress enact legislation to exclude most OTC financial derivatives from the CEA so that market participants may conduct transactions within a stable legal framework that promotes innovation, competition, efficiency, and transparency in the OTC derivatives markets, and reduces systemic risk. If Congress enacts the recommendations proposed by the Working Group, the CFTC would regulate futures on non-financial commodities with finite supplies. The CFTC also would be authorized to develop rules for establishing and regulating clearing systems for OTC derivatives. The Report also recommends CFTC jurisdiction over retail foreign exchange transactions that are not conducted by regulated entities. Finally, the Report recognizes that if a limited regulatory regime becomes necessary for financial OTC derivatives, then, depending on the specific market, existing regulation, and problems that regulation would be meant to address, Congress could appropriately build upon the CFTC's expertise in exchange-traded derivatives.

Q.12. Does the Report recommend the elimination of the exclusive jurisdiction of the CFTC over contracts of sale for future delivery?

A.12. The Report recommended that Congress modify the exclusive jurisdiction clause of the CEA to provide that, insofar as a so-called hybrid debt instrument may be subject to the CEA, the CFTC's exclusive jurisdiction should not be construed to limit the authority of the SEC and the bank regulatory agencies with respect to such instruments. In addition, the Report indicated that the Treasury, the Federal Reserve, and the SEC supported limiting application of the exclusive jurisdiction clause to contracts effected on designated contract markets and further limiting its application by clarifying that the CFTC's jurisdiction is not exclusive when the CEA or some other statute specifically grants another agency authority. However, the Report indicated that the CFTC did not support these additional limitations because it had not had time to evaluate all of the ramifications.

Q.13. How does the Report define "non-financial commodities with finite supplies?" Does that term, for example, include energy derivatives?

A.13. Many terms in the Report will need to be defined in legislative language to implement the Working Group's recommendations. The intent of the Report is to distinguish commodities that are readily susceptible to manipulation from those not readily susceptible. The term "non-financial commodities with finite supplies" could be interpreted very broadly to include many commodities, including various energy products, that are not readily susceptible to manipulation. As the report notes, the CFTC would retain its exemptive authority for these non-financial commodities, and it presumably would use that authority to ensure that protections against manipulation are not imposed where they are unnecessary.

Q.14. Doesn't the Report encourage the wholesale migration of financial derivatives to a less regulated environment? If this occurs, what would be the impact on traditional agricultural products traded on the exchanges? Would those markets be less liquid and more volatile than they are today?

A.14. The Report examines a set of products and concludes it is not necessary to regulate these products under the CEA in order to fulfill the objectives of the CEA. Thus, the issue is not one of a more or less regulated environment but rather an appropriate regulatory environment for these products. Some activity related to financial derivatives may well migrate off exchanges, particularly if market participants perceive that the current regulatory environment of exchanges is unnecessarily burdensome. The report of the CFTC's staff task force on alternative regulatory frameworks indicates that the Commission is sensitive to the need to reassess the regulatory environment of exchanges. Changes that the Commission can implement with its current authority may go a long way toward ameliorating any migration of activity. Even if some activity of financial products migrates, however, it is not clear that trading of traditional agricultural products will be less liquid or more volatile than today. Those with hedging demands in agricultural products will still turn to the exchanges, where they will be met by other market participants seeking to profit from supplying hedging products.

Q.15. The Report recommends that only principal trades be eligible for exclusion from the CEA and frequently refers to markets where "principals are trading for their own account." In recommending that only principal trades be eligible for exclusion from the CEA, doesn't the Report also permit a centralized electronic "dealers only" market for trading derivatives? Under the Report, couldn't a dealer's back office trade directly with its institutional customers at prices based upon, and reflecting a markup of, the centralized "dealers only" market price and still qualify for the exclusion? What is the policy behind encouraging the creation of markets that are not directly accessible to many market participants?

A.15. The rationale is that making markets directly accessible to non-dealers necessitates the introduction of costly customer protections that the vast majority of market participants do not want or need. The public interest in making these markets accessible to the general public is not at all clear. Absent a clear public interest, the associated regulatory burdens should not be imposed.

Q.16. The Report states that one of the conditions required to be met for exclusion of a bilateral swap agreement is that the transaction not be conducted on a MTEF (multilateral transaction execution facility) as that term is used under the current Swap Exemption in Part 35 of the CFTC Regulations. How does the CFTC interpret and apply this standard?

A.16. Only the CFTC can say how it currently would interpret and apply this standard. However, when the CFTC first issued the Swap Exemption it defined an MTEF as "a physical or electronic facility in which . . . members have the ability to execute transactions and bind both parties by accepting offers which are made by one member and open to all members of the facility." In the case of OTC derivatives, even where brokers are used, offers made by one counterparty are not open to all other counterparties. Rather, they are subject to the other counterparty meeting the credit standards of the counterparty making the offer. Any bids and offers subject to such bilateral credit criteria would seem not to be covered by the CFTC's MTEF definition.

Q.17. How does the CFTC define "transaction execution facility" and what is the CFTC's position on the meaning of "multilateral" in the context of the current Swaps Exemption?

A.17. Please see the answer to question 16.

Q.18. Would an electronic system that allows many swaps dealers simultaneously to view, react to, and execute against bids and offers for swaps transactions be covered under the definition of MTEF as stated in the current Swaps Exemption?

A.18. Again, such an electronic system would not be covered by the MTEF definition if transaction execution were made dependent on satisfaction of both counterparties' bilateral credit criteria or other counterparty-specific criteria.

Q.19. The Report would exclude from regulation under the CEA a standardized, fungible derivative traded on a principal basis among institutions if the trading occurs on a multilateral electronic or computerized trading facility. However, if that same derivative contract is traded on the same basis by the same institutions in a pit trading environment, the trading activity would be subject to full scale regulation by the CFTC. What is the basis for this disparity? What is the public policy rationale for treating electronic trading systems operated by the OTC derivatives industry differently than electronic trading systems operated by futures exchanges?

A.19. The exclusion for electronic trading systems for OTC derivatives is available only to systems that limit contracts to nonfinancial commodities and participation to "eligible swap market participants." Such electronic trading systems could be operated by futures exchanges. The need for regulation under the CEA depends on the nature of the commodities traded and the participants engaged in trading. The use of open outcry trading per se should not be a factor in determining whether regulation is necessary. However, the particular regulatory requirements may appropriately be tailored to the nature of the trading system. For example, there may be fewer opportunities for certain types of fraud in an electronic trading system than in an open outcry trading system.

Q.20. Historically, the CFTC has regulated derivatives clearing in the United States because of its expertise in that area. The Report expands that oversight authority to other federal agencies. What is the public policy for expanding the CFTC's authority to other federal agencies?

A.20. The Working Group's recommendation recognizes that several different agencies have expertise that might be relevant for the clearing of OTC derivatives, depending upon how that clearing system were structured. The recommendation seeks to maintain the maximum flexibility for the organizers of such a system, thereby enhancing its likely success.

Q.21. The Report recommends that clearing be permitted through foreign clearing systems that are supervised by a foreign regulator that "the appropriate U.S. regulator has determined satisfies appropriate standards." What is meant by "appropriate U.S. regulator" and "appropriate standards?"

A.21. In its recommendation related to clearing of OTC derivatives, the Working Group did not want to pre-judge the regulatory or supervisory structure that would be appropriate should market participants develop a clearing house. The Working Group thus proposed several options for the oversight of clearing systems, including reliance on foreign authorities when clearing systems are based abroad. Clearing houses in other countries already clear some OTC derivative products, and U.S. firms should be able to participate without subjecting the foreign organization to U.S. regulation as well as home country regulation. The Working Group thus recommends that foreign clearing systems be allowed if the "appropriate U.S. regulator" determines it "satisfies appropriate standards." The phrase "appropriate U.S. regulator" recognizes that one U.S. regulator already may have in-depth knowledge about a particular foreign clearing system. The CFTC is knowledgeable about foreign commodity clearing systems, the SEC has experience with foreign securities clearing systems, and the banking agencies have worked with their foreign counterparts that supervise banks and trust companies providing clearing and settlement services. The U.S. authority would evaluate whether or not the foreign regulatory regime was appropriate. In making this evaluation, it presumably would consult with the other U.S. regulators.

Q.22. In connection with a recommendation to change the language of the Treasury Amendment, the Report adopts a definition of "organized exchange" that has two parts: (1) it permits retail or agency trades and (2) it provides for self-regulation. What is meant by the term "retail or agency trades?" To be excluded from the definition of an "organized exchange," must the trades be for sophisticated parties and/or those that meet some asset test? Do agency trades have to be for non-sophisticated retail customers to be considered on an "organized exchange?"

A.22. The term "retail or agency trades" refers to transactions that are conducted by sophisticated parties (which can be defined as eligible swap participants) on behalf of an unsophisticated party or as an agent for another party, respectively. The Working Group recommended that the term "organized exchange" in the CEA should exclude a trading facility that limited transactions to those between sophisticated parties that trade Treasury Amendment instruments for their own accounts and not as agents for other persons. The Report does not differentiate agency transactions on the basis of whether the customers are "sophisticated parties" or "non-sophisticated retail customers."

Q.23. Under the Report's proposed change to the Treasury Amendment, could an exchange which is open to retail customers and which trades Treasury Amendment products other than foreign currencies opt out of the CEA simply by dropping its self-regulatory organization functions? If so, wouldn't that result lead to a form of regulatory arbitrage?

A.23. Yes, such an exchange could opt out of the CEA by establishing a separate trading system with those characteristics. But if the Treasury Amendment products traded were similar to existing Treasury securities futures it would opt into regulation under the securities laws. Differences between futures and securities regulation conceivably could motivate regulatory arbitrage, but any resulting public policy concerns could be addressed through regulatory coordination.

Q.24. If the Chicago Mercantile Exchange disbanded its self-regulatory operations, could it offer its foreign currency contracts and avoid being regulated as an "organized exchange?"

A.24. Under the Report's proposal, if the Chicago Mercantile Exchange disbanded its self-regulatory operations, it could offer foreign currency futures contracts for eligible counterparties and avoid being regulated as an "organized exchange" under the CEA. (It would seem appropriate for the regulated and unregulated products to be offered through separate trading systems, although the Report did not address this issue.) However, the Working Group unanimously recommends that the CEA be amended to provide that foreign currency futures and options are subject to the CEA if they are entered into between a retail customer and an entity that is neither regulated or supervised by the SEC or a federal banking regulator nor affiliated with such a regulated or supervised entity.

Q.25. If the Chicago Board of Trade continued its self-regulation, but told its members that no agency trades would be allowed on its exchange, would the Board of Trade be considered to be an "organized exchange?"

A.25. Under the Report's proposal, if the Chicago Board of Trade continued its self-regulatory operations, but restricted transactions in Treasury Amendment instruments only to its members (who qualify as eligible swap participants) acting for their own accounts, it would not be considered an "organized exchange" under the CEA.

Q.26. With respect to the Report's recommendation on changing the language of the Treasury Amendment:

a. Why should a system that agrees to self-regulate face government regulation while a system that avoids self-regulation face no government regulation?

b. What public policy is served by permitting United States futures exchanges to trade foreign currency or government security futures without any CFTC regulation if they eliminate their self-regulatory function?

c. What public interest is served by having government regulate the self-regulating entity but not the entity in the same business that does no self-regulation?

d. What public interest is served by permitting a system that allows agency trades for customers only outside the ambit of self-regulation to be excluded from regulation?

A.26. The Report's recommendations relating to the definition of an organized exchange were designed to differentiate exchanges that purport to offer the protections afforded by existing futures exchanges from other trading systems in Treasury

Amendment products. Under the proposed definition it should be clear to market participants whether they are benefitting from regulation under the CEA or not.

Q.27. What is the public policy rationale for excluding Treasury Amendment products from the provisions of the CEA unless those products are traded on a futures exchange?

A.27. Please see answer to question 26.