

PREPARED STATEMENT OF
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BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
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Mr. Chairman, Senator Sarbanes, and Members of the Committee. I am Robert G. Pickel, Executive Director and Chief Executive Officer of the International Swaps and Derivatives Association, Inc. (“ISDA”). I appreciate the Committee’s invitation to appear today to present ISDA’s views on proposed legislation to reauthorize the Commodity Futures Trading Commission (the “CFTC”), which administers the Commodity Exchange Act (the “CEA”).

I.

Overview

ISDA is an international organization, and its more than 650 members in 48 countries include the world’s leading dealers in swaps and other off-exchange derivatives transactions (“OTC derivatives”). ISDA’s membership also includes many of the businesses, financial institutions, governmental entities, and other end users that rely on OTC derivatives to manage the financial, commodity market, credit, and other risks inherent in their core economic activities with a degree of efficiency and effectiveness that would not otherwise be possible.

Congress substantially amended the CEA in the Commodity Futures Modernization Act of 2000 (the “CFMA”). The CFMA was adopted with broad bipartisan support after careful consideration over several years by four

Congressional Committees, including this Committee, and with the active support of the President's Working Group on Financial Markets (the "PWG"); namely, the Secretary of the Treasury, the Chair of the Board of Governors of the Federal Reserve System, the Chair of the Securities and Exchange Commission and the Chair of the CFTC.

The CFMA was intended to provide regulatory relief for the futures exchanges; ensure legal certainty and regulatory clarity for OTC derivatives; and remove the ban on single-stock futures trading. ISDA is of course principally interested in those provisions of the CFMA that were enacted to provide legal certainty and regulatory clarity for OTC derivatives.¹ For the reasons explained in Part II of this statement, ISDA believes that, based on the experience to date under the CFMA, Congress did achieve its objective of providing legal certainty and regulatory clarity for OTC derivatives in a manner that has reduced systemic risk and encouraged financial innovation. Moreover, from all indications, the CFMA seems to have been a broad-based success for the capital markets generally. ISDA commends the CFTC for the effective manner in which it has implemented the CFMA in accordance with Congressional intent. ISDA has and will continue actively to support passage of legislation to reauthorize the CFTC.

As the Committee is aware, there have been numerous proposals to utilize the reauthorization process as a vehicle for substantive amendments to the CFMA, including amendments relating to OTC derivatives. For the reasons discussed Parts II and III of this statement, ISDA believes there is no compelling need to make substantive changes to those portions of the CFMA governing OTC derivatives. While this Committee should of course consider the views of those who take a different position and advocate such amendments, we urge the

¹ ISDA's primary members are substantial users of the regulated futures exchanges. ISDA therefore supported the provisions of the CFMA that provided regulatory relief to the exchanges.

Committee to take a cautious approach to re-opening the OTC derivatives provisions of the CFMA. If any amendments are agreed to, they should be specifically targeted to identified problems requiring legislation and carefully crafted to avoid unintended collateral consequences that could undermine the legal certainty provided for OTC derivatives by the CFMA. In this connection, we also urge the Committee to ensure that all proposed substantive amendments to the CFMA are subject to advance review by the Committees of jurisdiction. Our experience in recent years demonstrates that the use of freestanding amendments offered to separate legislation without advance review by the Committees of jurisdiction is an undesirable method of considering changes to the CFMA.

II.

OTC Derivatives Under the CFMA

As noted, ISDA is principally interested in the provisions of the CFMA that provide legal certainty for OTC derivatives. The phrase “legal certainty” means simply that the parties to OTC derivatives transactions must be certain that their contracts will be enforceable in accordance with their terms. The availability of OTC derivatives transactions within a strong legal framework, such as that provided by the CFMA, is of vital importance. Any uncertainty with respect to the enforceability of OTC derivatives contracts obviously presents a significant source of risk to individual parties to those specific transactions. Moreover, any legal uncertainty creates risks for the financial markets as a whole and precludes the full realization of the powerful risk management benefits that OTC derivatives transactions provide.

As this Committee is aware, the CFMA framework for providing legal certainty is based on a long-standing consensus among Congress, key financial regulators, including the CFTC, and others that OTC derivatives transactions

generally are not appropriately regulated as futures contracts under the CEA.² The OTC derivatives provisions of the CFMA were intended by Congress to resolve the legal certainty issues with finality and, at the same time, reduce systemic risk and encourage financial innovation. ISDA's experience over the past several years indicates that these objectives have been achieved.

A survey of corporate usage of derivatives released by ISDA in April 2003 indicated that 92 percent of the world's largest businesses use OTC derivatives for risk management purposes and that 94 percent of the 196 U.S. companies included in the survey do so. Significantly, the use of OTC derivatives to hedge interest rate, foreign currency and credit default risks increased substantially in the last four years, evidencing the importance of OTC derivatives as a tool to manage risk in periods of economic downturn and uncertainty. As Federal Reserve Chairman Alan Greenspan noted before this Committee on March 2, 2002, OTC derivatives "are a major contributor to the flexibility and resiliency of our financial system."³

The reductions in systemic risk resulting from enactment of the legal certainty provisions of the CFMA have *not* come at the expense of financial innovation. New types of OTC derivatives have gained increased market acceptance since enactment of the CFMA. For example, the significant growth in credit default swaps to manage credit risk has been greatly enhanced by the legal

² In the late 1980's, the use of interest rate and currency swaps and other OTC derivatives transactions to manage financial risks grew rapidly. At that time, there was a consensus that OTC derivatives were not "futures" contracts. Nevertheless, because of certain perceived similarities between OTC derivatives and exchange traded futures contracts, there was residual concern that the CFTC or a court might treat OTC derivatives contracts as futures, which would render them illegal and unenforceable by reason of the CEA's exchange trading requirement.

³ Moreover, as discussed more fully below, the reduction in systemic risk resulting from the use of OTC derivatives was also evident in the energy markets following the collapse of Enron in 2001. Indeed, it appears that the legal certainty provisions of the CFMA and the related provisions of the Bankruptcy Code (adopted by Congress in 1990) may have enhanced the ability of market participants to deal effectively with events such as the collapse of Enron.

certainty provisions of the CFMA. Similarly, businesses ranging from ski resorts to beverage producers have begun to use weather derivatives to hedge the risk of adverse climate conditions on their businesses. Again, the legal certainty provisions of the CFMA have encouraged dealers to develop, and businesses to use, an increasing range of new kinds of OTC derivatives to manage additional types of risk. Finally, the legal certainty provisions of the CFMA removed the regulatory barriers to clearing with respect to OTC derivatives and, while collateralized transactions remain more prevalent, clearing proposals have been advanced recently and the emergence of these proposals attests to the positive effects of the CFMA on financial innovation.

To summarize, ISDA's experience to date under the CFMA indicates that Congress did indeed achieve its objective of providing legal certainty and regulatory clarity for OTC derivatives in a manner that would both reduce systemic risk and encourage financial innovation. Equally significant, three events since the passage of the CFMA have in many ways "stress tested" the OTC derivatives markets and the applicable provisions of the CFMA itself. The results have been encouraging.

First, there is no question but that the CFMA structure enabled financial institutions and the American business community to deal with the economic downturn in the early part of this decade in a more effective manner. The well-publicized events leading to Enron's bankruptcy filing in December 2001 presented a second test. Enron raised serious concerns involving accounting practices, securities law disclosures and corporate governance policies. These issues received serious attention from policymakers and led to intensive investigations and enforcement actions, including actions based on the CFMA, by the CFTC and other regulators. Had Enron complied with accounting and disclosure requirements, it could not have built the "house of cards" that eventually led to its downfall. The market in the end exercised the ultimate

sanction over Enron and the market for OTC derivatives functioned as expected and with no apparent disruption.

The equally well-publicized transactions of Enron and others in or with respect to the California energy market presented a third test involving different public policy questions; namely, the design of the California electricity market, the lack of adequate reserves, demand response relative to growing electricity demand and possible manipulation of the wholesale market. ISDA views any credible allegations of “manipulation” in financial or other markets as a serious matter requiring attention and therefore welcomed the investigations by the appropriate federal agencies and departments, including the CFTC, the Federal Energy Regulatory Commission (FERC) and the Department of Justice. Both FERC and the CFTC initiated a series of enforcement actions employing the tools available under existing law, including the CFMA. Based on this experience, there does not appear to be any specific evidence that the Commission’s anti-manipulation authority is deficient. Again, the CFMA contributed positively to the ability of the markets to respond effectively to a difficult situation.

III.

Possible Amendments to the CFMA Affecting OTC Derivatives

As noted, there have been several proposals to amend the provisions of the CFMA governing OTC derivatives. The most far-reaching of these proposals involve OTC derivatives based on foreign currency. One such amendment was included in S. 1566, which was approved on July 29, 2005, by the Senate’s Committee on Agriculture, Nutrition and Forestry in legislation (S. 1566) to reauthorize the CFTC. ISDA has concerns with the proposed amendments affecting foreign currency transactions, including those contained in S. 1566, and welcomed the recent decision of the PWG to review the relevant policy issues. In addition, ISDA has concerns with respect to proposals that may be advanced as the legislative process moves forward to amend the CFMA provisions applicable

to OTC derivatives based on energy and other “exempt commodities.” ISDA’s comments on these proposed amendments to the CFMA are set forth below.

Foreign Exchange Contracts-*Zelener* Issues. In the CFMA, Congress revised the so-called Treasury Amendment (the core provision of the CEA governing foreign exchange contracts) to provide legal certainty with respect to OTC foreign exchange contracts and, in so doing, gave the CFTC jurisdiction over certain specific transactions in foreign exchange contracts, but only if and to the extent those contracts are “futures” or “options”. In *CFTC v. Zelener*,⁴ the U.S. Court of Appeals for the Seventh Circuit held that the foreign exchange contracts before it were not “futures contracts” and that the CEA’s anti-fraud rules were therefore not applicable. In ISDA’s view, the *Zelener* case was correctly decided based on the evidence before the court, does not preclude the CFTC from successfully bringing similar cases in the future,⁵ and does not provide a “road map” for an “end run” around the CEA that can be “exported” to physical commodities such as heating oil and grain.

At the same time, however, ISDA recognizes that any fraudulent or manipulative activity involving the capital markets does warrant attention. In the case of the foreign currency markets, the involvement of the Department of the Treasury and the Federal Reserve (working in this case through the PWG) is critical and Congress has so recognized since the original adoption of the Treasury Amendment in 1974. Thus, while ISDA does not believe that statutory changes are necessary or warranted as a result of the *Zelener* decision, it could

⁴ 373 F.3d 861 (7th Cir. 2004).

⁵ In remarks prepared for delivery on March 17, 2005 at the Futures Industry Association International Derivatives Conference, CFTC Commissioner (and then Acting Chair) Sharon Brown-Hruska stated that “while developments like *Zelener* represent a set-back to our enforcement authority, I do not believe they preclude us from prevailing in these cases, even in the Seventh Circuit. A more focused litigation strategy, one that relies upon the extrinsic evidence surrounding the formation of the contract should, in our view, allow us to prevail in the future. . . .”

support a carefully crafted amendment if the PWG concludes that a legislative change is appropriate given the totality of the circumstances. ISDA will therefore give any such PWG recommendation serious consideration.

ISDA does believe, however, that in principle any such amendment should be quite narrow in scope. Specifically, in ISDA's view, if the CFTC's jurisdiction is to be expanded to include agreements, contracts and transactions that are *not* futures or options, that expanded jurisdiction should be expressly limited to authorizing the CFTC to pursue fraud claims in transactions in foreign exchange contracts between retail participants (i.e., participants who are not eligible contract participants under the CFMA) and otherwise unregulated persons.

Such a narrow approach has two distinct and important benefits. First, it will reduce the risk of unintended collateral consequences that could undermine the legal certainty provided by the CFMA for OTC derivatives. The risk of such unintended collateral consequences is neither speculative nor academic. For example, S. 1566 would amend section 9 of the CEA to clarify the CFTC's jurisdiction with respect to false reporting. In its explanation of that amendment, the proposed Report of the Committee on Agriculture, Nutrition and Forestry on S. 1566 contains the following statement:

The Committee concurs with the CFTC's consistent position that even if a transaction is excluded from the CFTC jurisdiction under Section 2(g) [of the CEA as added by the CFMA], the false reporting of such a transaction is a separate act and remains a violation of Section 9 so the CFTC has authority to prosecute.

The effect of this statement, which in ISDA's view does not follow from a reading of the statute itself, is that an allegedly false statement made by a person to a third party will trigger CFTC jurisdiction over that person even if the statement is made about a contract with respect to which the CFTC has no jurisdiction, including anti-fraud jurisdiction.

The position that the CFMA exclusions such as Section 2(g) protect only the “agreements, contracts or transactions” themselves and not the persons who participate in those transactions is inconsistent with the understanding of market participants concerning the scope of the legal certainty provisions of the CFMA and will likely erode the legal certainty protections intended by Congress in 2000. Moreover, such a construction is unnecessary to achieve the apparent legislative objectives, which ISDA supports, with respect to Section 9.⁶

The second benefit of a narrow approach to any *Zelener*-related amendment to the CEA is that it will limit the extent to which the CFTC is required to divert its limited resources from its core function of providing effective oversight of exchange traded futures and options contracts. Congress has on prior occasions evidenced a healthy skepticism toward proposals that would enlarge the CFTC’s consumer protection mandate with respect to contracts not otherwise subject to its jurisdiction and it should continue to do so.

Foreign Exchange Contracts-Affiliates and Solicitors. Proposals have been made to limit the ability of firms to create a so-called “shell” futures commission merchant (an “FCM”) that would enable an entity related to the shell FCM (a “material affiliated person”) to qualify under the Treasury Amendment (as revised by the CFMA) to engage in OTC foreign exchange futures transactions with persons who are not eligible contract participants. Under these proposals, an FCM would have to be well capitalized and engaged in the conduct of the regulated futures business. In addition, proposals have been made to require persons who market transactions covered the Treasury Amendment to register with the CFTC unless the person is either an entity otherwise eligible under the Treasury Amendment to engage in the transaction or an employee of such an entity.

⁶ In this connection, ISDA notes that the energy legislation enacted earlier this year contains provisions intended to improve the quality of reporting by all parties to many energy transactions.

If appropriately drafted, ISDA could support amendments to address the shell FCM and unregistered solicitor issues. ISDA could not, however, support amendments to the CEA that would prohibit those who are material associated persons with respect to broker-dealers from engaging, in accordance with the CFMA, in OTC foreign exchange futures transactions with persons who are not eligible contract participants. There has been no evidence of any inappropriate conduct in transactions involving these entities and they are generally well capitalized.

Energy and Other Exempt Commodities. As the Committee is aware, in recent years, proposals have been offered in the Senate in connection with energy-related legislation to amend the provisions of the CFMA providing legal certainty for OTC derivatives based on energy and other so-called “exempt commodities” These proposals, which would expand regulation of the OTC markets involving exempt commodities, have been consistently opposed by the PWG on policy grounds and, in case of energy-based derivatives, on the additional basis that enforcement actions taken by regulatory agencies and the Department of Justice rendered them unnecessary. ISDA shares the views of the PWG and urges the Committee to oppose any amendments to the CFMA based on these prior proposals.

IV.

Conclusion

OTC derivatives contribute substantially to the flexibility and resiliency of our financial system. They allow businesses, financial institutions, governmental entities and other end users to manage the financial, commodity, credit and other risks inherent in their core economic activities in an efficient manner. The CFMA provided legal certainty and regulatory clarity for OTC derivatives in a manner consistent with the long-standing policies of Congress and the CFTC that OTC derivatives are not appropriately regulated under the CEA as futures contracts.

This policy, as codified in the CFMA, materially reduces systemic risk and encourages financial innovation.

On behalf of ISDA and its members, I thank you for this opportunity to present our views and am prepared to respond to any questions you may have.