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COMMENT

TESTIMONY OF

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LEHMAN BROTHERS

BEFORE THE COMMODITY FUTURES TRADING COMMISSION

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Good morning. I want to begin by thanking Chairman Rainer for inviting me to participate on this esteemed panel to share my views on the historic, unprecedented and positive steps recently taken by the Commission to modernize and strengthen the exchange-traded and over-the-counter ("OTC") derivatives markets. Today, I will confine my comments mainly to the Commission's proposals concerning legal certainly for OTC derivatives, a topic on which I have spoken and written extensively over the past twenty years.

As most of you know, today, the OTC derivatives market is extensive and global, with trillions of dollars in notional amounts outstanding. Back in the 1970's, when I was an attorney with the SEC and, later, the first Director of the Division of Trading and Markets at the Commission, the OTC derivatives market as we know it now simply did not exist. At that time, fundamental questions regarding legal certainty centered on exchange-traded instruments, such as Ginnie Mae futures and the extent to which the Commission or the SEC could claim jurisdiction over exchange-traded products involving securities. These uncertainties were remedied by the Shad-Johnson Accord, a gentlemen's agreement between the then-chairs of the Commission and SEC that was enacted into law in 1982.

By the time the nascent OTC swaps market began to develop in the early 1980's, I was practicing as a partner at Cadwalader, Wickersham & Taft where an increasingly significant part of my practice entailed attempting to fit new and novel OTC products into a federal commodities and securities law framework that was not designed to regulate such OTC products, markets or participants. In the 1980's, legal uncertainty shifted to whether various OTC derivatives, such as swaps and hybrids, constituted "futures contracts" and, as result, could not be offered and sold under the Commodity Exchange Act ("CEA") in the U.S. except on a Commission-regulated exchange.

Given that swaps and other OTC derivatives were at the time created to be traded on a customized basis OTC, the exchange-trading requirement posed a real threat of shutting down financial innovation and, perhaps more significant, rendering such transactions subject to recission and

unenforceable. Through Commission action in its 1989 Policy Statement Concerning Swap Transactions and its 1990 Statutory Interpretation Concerning Certain Hybrid Instruments, the Commission used the interpretative tools it possessed to enhance legal certainty for such products. These noble efforts did, in fact, decrease legal uncertainty surrounding swaps and hybrids, but only in the limited fashion available under a statutory regime that categorically prohibited OTC "futures" while not defining what a "future" is.

At the same time that the Commission was taking action to promote legal certainty for many swaps and hybrids, however, courts were handing down decisions broadly interpreting "futures contract", thereby undercutting the beneficial impact of the Commission's actions. Most notably, the 1989 case, CME v. SEC, (or "IPS case") and the 1990 Transnor decision set forth judicial precedent providing, essentially, that transactions with an element of valuation in the future (i.e., virtually all derivatives) were susceptible to being labeled "futures" and unenforceable. This judicially-fostered uncertainty as to the scope of the term "futures contract" injected a high degree of risk in the growing OTC derivatives market and left participants vulnerable to counterparties on the losing end of a trade walking away by claiming the transaction was an illegal off-exchange future. This risk, in turn, contributed to increased systemic risk.

It became apparent that legal certainty under the CEA and its concomitant risk-reducing benefits could not progress without a statutory fix. Thus, in 1992, Congress enacted the Futures Trading Practices Act, which, under Title V, empowered the Commission to exempt swaps, hybrids and other OTC derivatives from the CEA's exchange-trading and most other requirements (except securities-based transactions subject to the Shad-Johnson Accord). Significantly, this authority was granted without requiring a predicate finding that a transaction was indeed a futures contract, which freed the Commission to use such power without first labeling covered transactions futures. The Commission promptly exercised its new Title V authority to exempt many OTC swaps, hybrids and energy transactions falling within the statutory criteria for such exemptions.

Nevertheless, as history has demonstrated time and again, financial innovation continued to outpace regulation, with the result that numerous OTC derivatives did not fall squarely within the parameters of the Swaps, Hybrids and Energy Exemptions. In particular, the evolution of electronic trading facilities and techniques for swaps cast doubt on the applicability of the Swaps Exemption in light of that exemption's criteria that covered transactions cannot be standardized and fungible or be offered and sold through a multilateral transaction execution facility ("MTEF").

The persistent problem of regulatory catch-up warrants discussion. Time and time again, Congress, regulators and the courts struggle to improve Depression-era financial market laws within the confines of those laws' basic structure – regulation-by-definition. Too often, policy depends on anachronistic labels that the OTC derivatives market has rendered meaningless. Similarly, formal policymaking by necessity occurs against the backdrop of reality as it exists at the time; the MTEF criteria of the Swaps Exemption exemplifies this trend as, at the time of the exemption, swaps were not traded on MTEFs. This phenomenon is not surprising, given that laws, rules and cases by their terms address today's problem in retrospect and cannot in and of themselves readily anticipate the challenges of tomorrow.

With this brief historical overview in mind, it is appropriate to note that the Commission's forward – looking and creative actions to promote legal certainty for OTC derivatives avoid many regulatory pitfalls of the past and therefore mark an important turning point in federal market regulation. Specifically, the proposed revisions to the Part 35 Swaps Exemption would expand the exemption to: cover "bilateral transactions" (instead of simply those labeled "swaps"); clarify that certain electronic trading mechanisms are not MTEFs such that trading on them would not obviate the availability of the exemption; provide for the clearing of OTC swaps through certain regulated clearing organizations; remove the requirement that covered transactions cannot be fungible or standardized; and clarify that netting will not preclude the availability of the exemption.

The Bilateral Contract Exemption retains the current Swaps Exemption's criteria that eligible swap participants must be parties to covered transactions, but renames them "eligible participants". As suggested above, the restrictions on trading through MTEF's remain (albeit in clarified form) and the prohibition on clearing now exists only for transactions cleared through non-regulated clearing facilities. The revised rule reflects the recommendations of President's Working Group Report on OTC Derivatives and the Commodity Exchange Act issued in April 1999 and deserves praise for responsiveness as well as for contributing significantly to market stability and efficiency.

By proposing to transform the Swaps Exemption into a generic Bilateral Transaction Exemption, the Commission has recognized the limits of regulation-by-definition, a truly historic and remarkable advancement. Likewise, the proposal embraces the principle of market evolution by relaxing criteria that no longer make regulatory sense in today's rapidly-changing world (such as standardization) and accommodates technological progress that has altered the nature of trading and clearing in the OTC derivatives market. The proposed Part 35 exemption, thus, would reduce, significantly, the legal uncertainty currently existing for novel OTC derivatives, those that are cleared in accordance with the

exemption and those traded through electronic mechanisms that are not defined as MTEFs under the Commission's proposed part 36 rules. In the latter regard, transactions conducted on single-dealer, communications and voice brokerage systems would qualify for the exemption.

Equally significant to the OTC derivatives market and participants, the Commission's proposal incorporates provisions that broadly restrict counterparties from voiding, rescinding or recovering payments under OTC derivatives transactions solely on the basis of non-compliance with the CEA.

These non-repudiation proposals exempt, from the private right of action provision of the CEA, Section 22(a), actions to void or rescind transactions by parties qualifying as "eligible participants" under the bilateral transaction exemption, based solely on the failure of that party or the transaction to comply with the exemption. Similarly, the proposal exempts, from Section 22(a), actions to void or rescind transactions that qualify under the policy statement or hybrid interpretation solely on the basis of non-compliance with the CEA or Commission rules. By exempting from Section 22 actions regarding OTC derivatives that rely on the Policy Statement and Hybrid Interpretation because they do not qualify for the exemption by virtue of the applicability of the Shad-Johnson Accord, the non-repudiation provisions grant such securities-based OTC derivatives a measure of legal certainty that previously was unavailable under the statutory restrictions of Title V. This measure demonstrates a creative commitment to legal certainty under less than optimal statutory conditions.

This revolutionary restriction on the ability of counterparties to exploit the CEA for purposes of reneging on OTC derivatives fundamentally enhances legal certainty and contributes to global financial market stability. Too often, counterparties with the wherewithal to meet their OTC derivatives obligations have used legal uncertainty under the CEA to simply avoid losing money on a trade. One case with the wrong outcome has the potential to jeopardize an entire market. This unfortunate reality has plagued market participants and distorted risk management techniques, given that it's difficult to quantify and measure a put based on legal uncertainty. Many times, this legal risk is not included in risk reports due to difficulties in quantifying it. This welcome and long-awaited clarity will lay to rest the uncertainty related to OTC derivatives' enforceability, leaving market participants with greater resources to improve market, credit, operational and technological risk management techniques.

On the topic of risk management, broadly speaking, I wish to conclude my comments by noting that the proposed improvements to the Commission's regulatory regime prove significant and laudable, yet remain subject to a legislative framework that is not flexible nor forward-looking.

By commending the proposal's advancements concerning legal certainty, I do not wish to imply that additional measures to help reduce systemic risk are not necessary or desirable. The Commission has come a long way in taking progressive and prudent action using its authority under the CEA. As a complement, I believe it is incumbent on the financial market industry to continue to work diligently with government in the area of "best practices" to help ensure that the OTC derivatives market continues to flourish in an efficient, safe and innovative way. In this connection, the Commission's use of enforcement proceeds in the Refco matter to foster best practices in order entering exemplifies the benefits of best practices. To that end, as a member of the Futures Industry Institute, which is focussing on best practices initiatives, I encourage the Commission to work with us in developing a "best practices" framework for financial market participants.