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COMMENT

October 13, 1998

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Over-the-Counter Derivatives Concept Release

Dear Ms. Webb:

The International Swaps and Derivatives Association, Inc. ("ISDA") is pleased to submit this letter to the Commodity Futures Trading Commission (the "CFTC"). The CFTC has issued a Concept Release entitled "Over-the-Counter Derivatives", 63 FR 26114 (May 12, 1998) (the "Concept Release"),[1] which seeks a wide range of information about swaps and hybrid instruments. Due to the size and character of ISDA's membership and the nature of its mission, ISDA believes that it is able to provide unique insights in response to the questions posed by the CFTC in the Concept Release.

ISDA is an international organization whose membership comprises over 360 of the world's largest commercial, merchant and investment banks and other corporations and institutions that engage in significant activities in swaps and other privately-negotiated derivatives transactions (collectively, "swap transactions"). A list of ISDA's current members is attached to this letter as Annex A. In addition to our Primary Members, who represent all the major dealers in swaps and derivatives, ISDA has a growing number of Subscriber Members, many of whom are active end-users of swaps and derivatives. Additional information about ISDA and its activities can be found on its web site, **www.isda.org.**

One of ISDA's main goals since its inception has been to promote legal certainty for swap transactions. ISDA has sought to establish (i) clarity concerning how swap transactions will be treated under U.S. law and laws in other jurisdictions, (ii) certainty that they will be legally enforceable and not subject to avoidance and (iii) certainty that key provisions in swap

[1] All references to the Concept Release are to the version that appeared in Federal Register, Vol. 63, No. 91, Tuesday, May 12, 1998, and all page references are to that publication.

transactions (including termination and netting provisions) will be enforceable, even in the case of bankruptcy of one of the parties. For example, ISDA has worked with Congress to pass legislation establishing the enforceability of master agreement netting provisions in the case of insolvency of a U.S. counterparty. ISDA is currently working with Congress, the President's Working Group on Financial Markets and other private sector representatives to achieve further clarification in these areas. In addition, ISDA has developed model swap contracts that are used in the United States and around the world by the vast majority of swap participants for their transactions.

Summary

Swap transactions have not changed in any fundamental way since the CFTC adopted its Swap Exemption in 1993. Growth in volumes, development of new products and an expanding universe of beneficiaries of these risk management tools are all characteristic of swap activity over the last five years. These positive developments provide no basis for the extensive review set forth in the Concept Release, let alone the regulatory regime implicit in its scope. The CFTC's other justifications for its review—alleged market failures and losses, perceived fungibility of transactions and demands for swap clearing—divert attention from what users of these transactions truly require: a clear declaration that swaps are not futures subject to the Commodity Exchange Act (the "CEA").

Background to ISDA's Response

ISDA is providing this response to the Concept Release for several reasons. First, ISDA has attempted in this letter to be responsive to the CFTC's stated goals "to stimulate public discussion and to elicit informed analysis."[2] ISDA is concerned, however, by statements contained in the recent House Banking Committee testimony of CFTC Chairperson Brooksley Born in response to the failure of Long Term Capital Management, which suggest to ISDA that, at least in her mind, many of the issues raised in the Concept Release are already resolved.

ISDA continues to believe that the Concept Release is an overly-broad and potentially disruptive means of accomplishing the CFTC's stated goals. ISDA agrees with Commissioner Holum's statement in her dissent to the issuance of the Concept Release, that "the release goes beyond the scope of regulatory review by exploring regulatory areas that may be inapplicable to an OTC market."[3] The broad scope of the CFTC's review is potentially disruptive due to the nature of the CEA and the effect under the CEA of a determination that a transaction is a futures contract and constitutes an illegal, off-exchange future if it is not executed on an organized exchange. A more narrowly defined CFTC review or a review through other channels, such as Congress or the President's Working Group on Financial Markets, would have accomplished the CFTC's stated goals without running the same risk of market disruption.

The CFTC has described the Concept Release as merely a series of questions, but reaction to Long Term Capital confirms what has long been suspected: at least some at the CFTC already have their answers. On October 1, CFTC Chairperson Born delivered unprecedented

[2] Concept Release, p. 26116.

[3] Concept Release, p. 26127.

testimony before the House Committee on Banking and Financial Services. Her testimony, which reflected her own views and not those of the CFTC, casts serious doubt on repeated assertions that there is "no preconceived result"[4] and "no preconceived notion"[5] in undertaking the review set forth in the Concept Release. Her testimony indicates that she believes that OTC derivatives require more reporting and recording, more disclosure, more adequate prudential controls and greater price transparency even though these are among the questions for which the CFTC is seeking input through the Concept Release. Other observers of Long Term Capital have focused on the size and diversity of Long Term Capital's portfolio of investments, its extensive use of leverage, the squeeze on its bond and equity positions caused by extraordinary events in the financial markets and the orderly manner in which investors and lenders acted to protect their exposures.[6] In her testimony, Chairperson Born simply blamed derivatives.

ISDA nevertheless welcomes the opportunity to share its perspective on a successful, thriving business for which many parties can take credit. First and foremost, this success can be attributed to the many active participants in the swap business. These participants have relentlessly pursued innovation and have consistently responded to the ever increasing need to develop more effective risk management tools. In addition, Congress has seen the importance of providing legal certainty for these transactions, which is fundamental for users to be able to rely on them to manage risk. Finally, the CFTC and other agencies, such as the Federal Reserve Board, the Department of Treasury and the Securities and Exchange Commission, have recognized the importance of these transactions and have worked to construct a framework that has enabled the private sector to pursue innovation on a firm regulatory foundation.

ISDA is also aware of the interest among members of the President's Working Group on Financial Markets and members of Congress in a study of swap transactions. Although ISDA continues to see no pressing need for a study because substantial problems have not been identified, ISDA is prepared to participate in such a study. ISDA is confident that such a study will demonstrate that these transactions are powerful and effective tools for managing the risks that users face in their businesses and that greater regulation would make these transactions more costly and less available to many users. ISDA views this letter as just one part of the consideration by Congress and the President's Working Group over the coming months of the importance of swap transactions and the appropriate legal and regulatory framework for them.

History of the CEA

The history of the CEA and of the efforts of Congress and the CFTC to address the significant developments in the financial services industry in the last quarter century have been

[4] Concept Release, p. 26116.

[5] See also Testimony of Brooksley Born, Chairperson of the CFTC, before the House Committee on Banking and Financial Services, July 24, 1998, and Testimony of Brooksley Born, Chairperson of the CFTC, before the Subcommittee on Risk Management and Specialty Crops of the House Committee on Agriculture, June 10, 1998.

[6] See Testimony of Alan Greenspan, Chairman of the Federal Reserve Board, before the House Committee on Banking and Financial Services, October 1, 1998, and the Testimony of William McDonough, President of the New York Branch of the Federal Reserve, before the House Committee on Banking and Financial Services, October 1, 1998.

detailed before in various contexts, including in the Concept Release. ISDA does not propose to review that history here. For a description of that history, please refer to our written testimony submitted to the Senate Committee on Agriculture, Nutrition, and Forestry in connection with its July 30 hearing on the Concept Release, a copy of which is attached to this letter as Annex B.

The CFTC's summary of this history in the Concept Release may be an accurate description of the regulatory milestones, but it reinterprets the significance of these events in ways that are contrary to the intent of Congress and inconsistent with past policies of the CFTC. At each stage—the 1989 Swaps Policy Statement,[7] the Futures Trading Practices Act of 1992, the 1993 Swaps Exemption[8] and the 1994 Hybrid Instrument Exemption[9]—a decision was made by Congress or the CFTC not to regulate swaps and hybrid instruments as futures under the CEA. At no time has Congress or the CFTC determined that swaps or hybrid instruments are futures contracts subject to regulation under the CEA.

In recent months the CFTC has attempted to transform a mandate to exempt into a grant of jurisdiction. The Concept Release and other recent comments and actions by the CFTC, including its comment on the SEC's broker-dealer lite proposal, reflect a view that Congress intended to grant the CFTC general regulatory, and not merely exemptive, authority over these transactions. This reinterpretation of Congressional intent is the source of the concern expressed by the private sector, other members of the President's Working Group and members of Congress that has motivated legislative efforts to impose a standstill on the CFTC to delay its proceeding with regulatory initiatives in this area.

<u>Recent Developments</u>

The Concept Release seeks extensive information and views on the ways in which swap transactions have evolved over the more than five years since the Swaps Exemption was adopted. That evolution has manifested itself in growth in the volume of these transactions and the development of new transactions designed to manage specific forms of risk. These developments continue trends that have been characteristic of swap activity since swaps were first developed in the late 1970's and do not reflect any fundamental change in the nature of swap transactions.

A. <u>Consistent Regulatory Framework</u>

Before any discussion of changes in swap activity in recent years, however, it is important to focus on one constant throughout this period: the unchanging regulatory framework applicable to these transactions. Users of these privately-negotiated, custom tailored transactions have a fundamental need for certainty that their contracts will be legally enforceable. They have been able to engage in these transactions and develop a course of dealing in reliance on a consistent regulatory framework. While there are transactions, such as swaps involving securities, that would benefit from greater clarity in this regulatory framework, the prospect of

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[7] 54 FR 30694 (July 21, 1989)
[8] 58 FR 5587 (Jan. 22, 1993)
[9] 58 FR 5580 (Jan. 22, 1993)

wholesale change in this framework would shake market confidence. The goal of any regulatory considerations in this area should be to build on this solid foundation without undermining the strength of the framework that currently exists.

The recent change to the CFTC's approach to agricultural trade options[10] is an example of the serious adverse effects that can occur when there is a change in the regulatory framework. Prior to these changes, the widely accepted understanding was that the Swaps Exemption covered swap agreements involving agricultural commodities and nothing that the CFTC had done suggested a contrary interpretation. The CFTC, in what purported to be an effort to make it easier for farmers, producers and intermediaries to manage risk, actually made it harder for them to do so by declaring that the Swaps Exemption could not be relied upon for transactions involving agricultural commodities. The effect has been to deny these parties an important risk management tool with no warning or ability to comment on this particular change. This episode is a worthwhile reminder that making changes in the existing regulatory framework can have serious, and often unintended, consequences and, accordingly, changes to that framework should be undertaken with the utmost care and consideration.

B. Growth in Volumes

By all measures, the outstanding notional amount of swap transactions has grown significantly since 1993, continuing a general trend that goes back to 1987 when ISDA commenced its market survey of swap activity. Yet even the ISDA survey is not indicative of the breadth of that growth due to the limited nature of the transactions that it seeks to measure.

The ISDA survey collects information on interest rate swaps, currency swaps and interest rate options (caps, collars and floors). The survey indicates that since 1993 the outstanding notional principal amount of these transactions has risen from $8.47 trillion to $29.04 trillion. Of course, the actual exposure involved in these transactions is a small percentage, typically one-half to two percent, of the total notional principal amount. The survey does not attempt to collect information on a wide range of other types of transactions, such as commodity swaps, equity swaps and credit derivatives. These transactions have either been introduced in recent years or are a much smaller portion of derivatives activity. It is these types of transactions that are likely to be the major sources of growth for the swap business.

The CFTC has cited this growth in volumes of swap transactions as a reason for undertaking its regulatory review. It is difficult to understand how growth, which is generally evidence of success, could justify the extensive review that the CFTC has undertaken. The volume of any activity, including swaps, can only increase where there is a demand for the service. The growth in the use of swaps is a direct result of the growing demand in all sectors of the economy—financial, industrial, agricultural, governmental and service-related—for tools that facilitate more efficient and cost-effective risk management. Satisfying that demand permits banks, manufacturers, farmers, government officials and others to focus on their core businesses and activities. The increased volume of swap transactions is evidence that these transactions respond to that demand.

[10] 63 FR 18821 (April 16, 1998)

C. New Products

Innovation has been a hallmark of the swap business since swaps were first developed. The continuing ability of participants to develop new products, employ new technologies and address business risks in new ways has permitted the industry to register significant growth rates year after year. Users of swaps have benefited from the many new tools that have been developed to manage risk more precisely and effectively. The new products developed in the last five years are the latest manifestations of that innovation.

The fundamental nature of these new products is no different from the transactions that existed in 1993. They are custom tailored risk management tools used by sophisticated parties, and are subject to the same corporate governance and risk management procedures that apply to more traditional products. There is no need for increased regulation of them; existing regulatory structures provide adequate oversight of these transactions. Further innovation in the swap business will be fostered by greater legal certainty for certain classes of swaps, such as swaps involving securities, and by a consistent, stable regulatory framework for swaps in general.

A business, financial institution or government faces many different types of risk in its day-to-day activities. One significant risk is market risk, or the exposure of an institution to fluctuations in the price of a commodity, the cost of funding or the value of a currency or investment. The vast majority of swap transactions have been developed to address these risks. An oil company uses a commodity swap to protect against fluctuating crude prices, a floating rate borrower fixes its cost of funding through an interest rate swap, a multinational corporation hedges its currency exposure with a currency swap and a shareholder locks in gain or loss through an equity swap. The ability to obtain these forms of protection against market risk has produced a sea change in approaches to risk management. The development of models for tracking market risk, particularly value-at-risk models, has also enabled companies to develop more finely tuned assessments of market risk that can be hedged with swap transactions.

These transactions and models focus on only one form of risk—market risk. Recently, the focus of financial innovators has turned to developing methods to reduce the credit risk that a company or financial institution faces in its day-to-day activities. A company or financial institution has credit exposure to counterparties, customers, suppliers, clients and borrowers. Traditionally, a company has managed its credit exposure by establishing credit limits for parties with which it deals and monitoring their creditworthiness. These traditional methods continue to have merit, but they often involve extensive monitoring and are limited in their ability to fine-tune credit exposure. The term "credit derivative" covers a number of different types of transactions the purpose of which is to provide compensation to the purchaser of credit protection in the event of a credit event involving a third party reference entity. Although they focus on credit risk, credit derivatives are not fundamentally different from the tools that have been developed to manage market risk. With a credit derivative, a party can protect against the adverse effects of deterioration in the creditworthiness of a third party to which it has credit exposure in much the same way that a party can use a swap to protect against exposures it has to interest rates, currencies or commodity prices.

D. Nature of Participants

In reviewing changes in the nature of the parties that enter into swap transactions, several trends affecting swap participants can be identified. The vast preponderance of parties to these transactions are sophisticated institutions that need to manage a wide range of risks that they face in their businesses. Retail participants are rare, as has been the case throughout the history of these products.

For swap participants, the cost of capital is often a factor in deciding which business entity should serve as a swap counterparty. These considerations may even lead to the establishment of a separate subsidiary to take advantage of less onerous capital requirements. One offsetting factor that a company must consider is that the resulting fragmentation in a company's swap business can increase risk by minimizing the benefits of netting exposures under a single master swap agreement with a single entity. The cost of capital is a critical consideration in determining how swap business will be conducted, and capital considerations will continue to have implications for the ways in which participants, particularly dealers, conduct their business.

The universe of non-dealer, or end-user, participants has grown in recent years. More end users, such as municipalities, mutual funds and pension funds, are entering into swap transactions because they are now permitted to do so or because they have discovered the effectiveness of these risk management tools. These users are generally subject to appropriate oversight or a separate regulatory regime, such as the SEC's regulation of mutual funds, and are not likely to receive any appreciable benefit from additional CFTC regulation. ISDA believes that as these end-users continue to analyze the risks in their ordinary activities, and understand how swaps can address those risks, they will turn increasingly to custom tailored swap transactions.

The relationship between dealers and end-users has always been strong. While maintaining the fundamental presumption that each party should seek its own advice and determine the appropriateness of a particular transaction, swap participants recognize that a transaction must benefit both parties. As the General Accounting Office concluded in its recent report on sales practices for swap transactions, "most end-users were generally satisfied with the sales practice of the dealers with whom they entered transactions".[11]

[11] General Accounting Office, GAO/GGD-98-5, "OTC Derivatives: Additional Oversight Could Reduce Costly Sales Practice Disputes", p. 5.

E. Internal Procedures and Corporate Governance

The Concept Release rightly acknowledges the significant strides that have made in establishing adequate internal procedures and approaches to corporate governance issues to minimize the risk of loss on swap transactions. The Group of Thirty Report, the Derivatives Policy Group Framework and the recent efforts of the Basle Committee on Banking Supervision are all cited by the CFTC as evidence of the importance of these issues.

Each of these reports provides ample guidance to parties active in swap transactions on the issues to address when setting up internal procedures for conducting a swap business. It is difficult to see how government-mandated, or even government-recommended, procedures would improve on the benefits that can already be derived from these reports. ISDA has worked and will continue to work to raise the awareness of these prudent policies at institutions. In the end, however, the marketplace will provide the greatest motivation for parties to implement these recommendations. Those companies that act prudently will be better positioned because they will have minimized their exposure to unauthorized trades and operational errors that can adversely affect the profitability of their business.

F. Netting and Collateral

A critical feature of privately-negotiated swap transactions has always been that the parties to these transactions must make credit judgments about each other. Credit considerations continue to be a fundamental feature of these transactions, affecting a party's willingness to do business with a counterparty and the pricing of a transaction. This is in contrast to standardized, exchange-traded products where the credit of the clearing facility is the focus. It is not surprising, therefore, that parties continue to seek ways to reduce credit exposure to their counterparties, and the principal ways they have sought to reduce that exposure are netting and collateral arrangements.

The Concept Release refers briefly to the benefits of netting. At ISDA, explaining the benefits of netting has been one of our most important missions around the world. In addition, ISDA is increasingly seeing a demand for the use of collateral and a corresponding need to obtain certainty on the legal enforceability of collateral arrangements.

One milestone in the swap business in the last five years was the 1994 Amendments to the original 1988 Basle accord on capital of the Bank for International Settlements.[12] The 1994 amendments recognized for the first time the effectiveness of the close-out netting provisions of agreements, such as the Master Agreement published by ISDA, for reducing capital requirements. Among the three conditions to the ability to rely on close-out netting was a requirement that legal opinions be obtained to the effect that the close-out netting provisions of the agreement would be recognized in the event of the bankruptcy or insolvency of a

[12] Committee on Banking Regulations and Supervisory Practices (1988) International Convergence of Capital Measurement and Capital Standards; Committee on Banking Regulations and Supervisory Practices (1994) Amendment to the Basle Accord of July 1988.

counterparty. Since then, ISDA has embarked on a project to obtain these opinions, totaling 34 jurisdictions to date.

When close-out netting is enforceable, the benefits are substantial. By some estimates the reduction in exposure to a counterparty is greater than 50%, with a corresponding reduction in capital requirements. All these benefits rely, however, upon the underlying transactions being enforceable. If doubt were cast on the enforceability of any of these transactions, netting of exposures would become a guessing game, which would increase legal uncertainty and credit risk in dealing with U.S. counterparties. The success of legislators in passing netting legislation in the U.S. and other countries, the wisdom of regulators in implementing the 1994 Amendments to the Basle accord and the efforts of ISDA in collecting legal opinions would be seriously undermined. The CFTC, which indicates in the Concept Release an interest in facilitating netting, may in fact undercut benefits from netting by encouraging third party litigants to question the enforceability of certain swaps by claiming that they are illegal, off-exchange futures contracts.

The use of collateral has many similarities with netting. Both are means of obtaining substantial reduction in credit exposure, and both rely on the enforceability of an underlying legal document to achieve effective reduction in credit exposure. Furthermore, they can each provide significant capital benefits. The use of collateral has become increasingly common in swap transactions. This is true particularly in transactions between parties with good credit ratings.

ISDA has facilitated the use of collateral in several ways. First, it has published four forms of credit support documents, one governed by each of New York and Japanese law and two governed by English law. These documents are widely used to secure net exposures under an ISDA Master Agreement. ISDA has also begun the process of collecting collateral opinions from various jurisdictions on the enforceability of the New York law and English law forms of our credit support documents. Finally, in connection with its recent initiatives in the area of credit risk, ISDA is advocating greater consistency across jurisdictions in the use and treatment of collateral and will publish operational guidelines for collateral practitioners. These efforts are part of a general recognition by swap participants that collateral will play an important part in reducing credit exposure to a wide range of counterparties.

G. Automation and the Internet

The Concept Release refers to the implications of automation for the swaps industry. Also, while the Concept Release does not refer to the Internet specifically, the implications of Internet technologies raise new and interesting considerations for this industry as they have for virtually every other industry. As with other industries, technology and the Internet hold out the promise of greater efficiencies and lower costs and will undoubtedly generate innovations that that cannot be foreseen today.

ISDA has made two recent efforts to utilize technology to facilitate contractual relationships. First, ISDA has developed standards for the automated matching of confirmations that can be used by independent service providers. ISDA is not involved in the automatching process itself but has developed these common standards so that parties can choose service providers who have based their systems on agreed standards. This process matches confirmations of privately-negotiated trades already agreed to. It does not create any facility to make an open offer to all subscribers to the service to enter into a transaction. The goal of the automatching process is to reduce the operational risk of having unsigned or unaccepted confirmations outstanding for long periods after a trade is agreed to by traders on the telephone.

Most recently, ISDA has developed what it calls a protocol approach to amending the terms of master agreements executed by the parties. This approach uses ISDA's web site to facilitate the bilateral amendment of outstanding agreements to address market practice and definition issues identified by the marketplace. Its initial application is to address issues raised by European Economic and Monetary Union. The list of over 1,100 parties adhering to this protocol, which is available on the ISDA web site, is prime evidence of the varied nature of users of swaps around the world. The protocol approach addresses issues raised in the Master Agreement and ISDA's other publications and does not attempt to amend the material economic terms that are agreed to in specific transactions.

Market Failures and Losses

There simply has not been any pattern of market failures or losses resulting from the use of swap transactions that would warrant a comprehensive study of the market, much less increased regulatory oversight of the market. The Concept Release refers to "an increase in the number and size of losses even among large and sophisticated users which purport to be trying to hedge price risk in the underlying markets". The release then cites the 1997 GAO report on OTC derivatives.

Most of the losses cited in the GAO report relate to activities that are outside the scope of the transactions discussed in the Concept Release. Collateralized mortgage obligations, for example, are quite different from the OTC derivatives that the CFTC purports to be studying. Furthermore, the few losses cited in the GAO Report that related to swaps were hedges against exposures on other transactions. The GAO Report then focused on disputed losses, a small subset of the losses cited in the Concept Release, and reached the conclusion that there was no current need for additional regulation in this area. The Concept Release fails to acknowledge this conclusion.

Since swap transactions are most widely used to hedge other offsetting positions, it follows that many users of these instruments will experience losses on their derivatives positions when they incur gains on their offsetting positions. (Conversely, users will experience gains on their derivative positions when they incur losses on their offsetting positions). However, this is exactly how swap transactions are supposed to work, and this is exactly the result that many users of these instruments intend to achieve. Since this is exactly what the parties to these transactions desire, an increase in the volume and size of such "losses" that results from an increase in the volume of these transactions is by no means a cause for concern.

Swap transactions, like all financial instruments, entail the risk of loss. The fact that the magnitude of unintended and disputed losses relating to these instruments has not been significant in recent years is due, at least in part, to the widespread adoption of appropriate corporate governance and risk management procedures to govern their use.

Fungibility of Transactions

The CFTC expresses a view in the Concept Release that there is increasing standardization of swaps and related derivatives. The CFTC even suggests that certain types of swaps, which it does not identify, have become fungible as to their material economic terms. If true, this would have implications under the Swap Exemption, as the CFTC points out. Yet nothing could be further from the truth.

There are many developments in the industry that, viewed in isolation, could be considered evidence of increasing fungibility. ISDA is responsible for one of those developments: the standardization of documentation for these transactions. In addition to the Master Agreement, which is the industry standard for documenting swaps, ISDA has published credit support documents and a growing selection of definition booklets and form confirmations to address interest rate and currency swaps, commodity swaps, equity derivatives, government bond options, credit derivatives and other transactions. These documents provide a common vocabulary and structure for swap transactions. Yet a brief review of these documents will quickly reveal that there are many choices left to be made by the parties to a Master Agreement or to specific transactions. Most importantly, the specific economic terms of a transaction must still be agreed to by the parties. Swaps continue to be custom tailored risk management tools.

The volume of information available to participants, such as screens and broker prices, is also cited at times as evidence that swaps are becoming increasingly fungible. Much of this information has been widely available for years, although with advances in technology more and more users may have access to it. Using this information, users of swaps can more effectively negotiate transactions that address their specific need to manage risk. It is the ability to address these unique needs in a custom tailored way that distinguishes swaps from the standardized futures contracts available on the exchanges.

Finally, the fact that for certain types of swaps it is possible to get quotations from a large number of dealers is not evidence of their fungible nature. The liquidity that this depth of quotations represents should not be mistaken for fungibility. The quotations obtained from these dealers reflects each dealer's own assessment of rates and prices, its credit exposure to the party seeking the quotes and its interest in doing the business.

Clearing

The CFTC cites proposals for the clearing of swaps as among the reasons for undertaking its review of swaps set forth in the Concept Release. As far as ISDA is aware, the only active major proposal for swap clearing is the SwapClear facility under development by the London Clearing House. The few other clearing facilities that exist are limited to specific countries or markets.

Facilities for clearing swaps have been discussed almost as long as swaps have been around, yet not one of these facilities has proven commercially viable. It remains to be seen whether the current proposal for swap clearing will be commercially viable, let alone whether it will promote growth in swap activity. Regardless of its commercial viability, however, any effort to implement such an arrangement should not provoke a general review of the current regulatory framework for swaps. This is an isolated event that, if it needs to be addressed, can be addressed through narrow means that do not jeopardize the ability of users of swaps to continue to engage in individual transactions without the risk of a change in the regulatory framework for swaps.

As ISDA stated in its comment letter on the London Clearing House petition for an exemption from the provisions of the CEA, ISDA is concerned about any suggestion that swap clearing *per se* is not permitted unless the clearing facility has been exempted from the provisions of the CEA. The Swap Exemption identifies those few portions of the CEA that would apply if any swap transaction were ever found to be a futures contract. It does not imply that any swap transaction, including one not covered by the Swap Exemption, is a futures contract. The Swap Exemption provides greater legal certainty for swaps that satisfy its conditions, but neither Congress nor the CFTC intended that this greater legal certainty would be achieved by placing swaps that do not satisfy those conditions, including cleared swaps, within the ambit of the CEA.

The CFTC clearly confuses clearing with exchange trading. Accordingly, it is concerned about promoting fair competition and even-handed regulation with respect to exchange-traded products. If the CFTC is genuinely interested in achieving these goals, it should do so not by seeking to impose greater regulatory burdens on swaps and swaps clearing, but by exploring ways to ease the burdens on exchange-traded products. At a time when competition in the financial services industry is becoming increasingly global, imposing new burdens on one segment of the U.S. financial services industry to improve the relative domestic competitiveness of another segment is shortsighted and ultimately ineffective. Burdening one segment would undermine the competitiveness of the United States to the ultimate detriment of all segments of the industry and the U.S. economy.

Conclusion

The developments discussed in this letter—growth, innovation, effective risk management—are signs of success and are a testament to the ability of firms to respond to the needs of their counterparties when they are permitted to do so by a consistent regulatory framework that does not create unnecessary risks or costs. The goals of any changes to the regulatory framework should be to encourage continued growth, further innovation and greater responsiveness to the needs of participants. With the exception of providing greater certainty for swaps involving securities and swap clearing, there is nothing in the current regulatory framework that needs to be changed to achieve these goals. If the CFTC shares these goals, its review should focus on making changes to its regulatory framework, and advocating statutory changes before Congress, that will achieve them.

ISDA continues to question whether the issuance of the Concept Release was a helpful or necessary means for the CFTC to consider changes to its existing exemptions, but appreciates the opportunity to share our perspective with the CFTC. If you should have any questions or comments, please feel free to contact any members of the ISDA Board of Directors listed in Annex C.

Yours sincerely,

Mark D. Harding /RP

Mark D. Harding
Chairman

Richard E. Grove

Richard E. Grove
Executive Director and
Chief Executive Officer

ISDA PRIMARY MEMBERS

Abbey National Financial Products

ABN AMRO Bank N.V.

ABSA Bank Ltd.

AIG Financial Products Corp.

Allied Irish Banks, plc

Arab-Malaysian Merchant Bank Berhad

Artesia Bank N.V./S.A.

Asahi Bank, Ltd.

ASLK-CGER Bank N.V. S.A.

Australia and New Zealand Banking Group, Ltd.

Bacob Bank s.c.

Baden-Wurttembergische Bank AG

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Banca CRT- Cassa di Risparmio di Torino

Banca del Gottardo

Banca di Napoli

Banca di Roma S.p.A.

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Banco Espanol de Credito, S.A. (BANESTO)

Banco Espirito Santo e Comercial de Lisboa, S.A.

Banco Exterior de Espana, S.A.

Banco Portugues Do Atlantico

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Bank Brussels Lambert

Bank Handlowy w Warszawie S.A.

Bank Hapoalim B.M.

Bank Labouchere N.V.

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Bank of Nova Scotia

Bank of Scotland Treasury Services plc

Bank of Tokyo-Mitsubishi, Ltd.

Bankers Trust Company

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Banque Nationale de Paris

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ISDA PRIMARY MEMBERS

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BPI - Banco Portuges de Investimento S.A.

Caboto Holding SIM S.p.A.

Caisse Centrale des Banque Populaires

Caisse des Depots et Consignations

Caixa Geral de Depositos, SA.

Caja de Ahorros Y Monte de Piedad de Madrid

CARIPLO - Cassa di Risparmio delle Provincio

CEDEF Capital Services SA

CERA Bank C.V.

Ceskoslovenska Obchodni Banka, A.S.

Charterhouse Bank

Chase Manhattan Bank

Christiania Bank

CIBC World Markets

Citibank, N.A.

Cofiri SIM S.p.A.

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Credit Lyonnais

Credit Suisse Financial Products

Creditanstalt-Bankverein

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Daiwa Bank, Ltd.

Daiwa Europe Bank Plc

Den Danske Bank

Den Norske Bank ASA (DnB)

Deutsche Morgan Grenfell

DG Bank Deutsche Genossenschaftsbank

Die Erste Osterreichische Spar-Casse Bank AG

DKB Financial Products, Inc.

Donaldson Lufkin & Jenrette

Dresdner Bank AG

Elf Trading S.A.

Enron Corporation

First National Bank of Chicago

First Union National Bank

Fuji Bank Ltd.

Fuji Capital Markets Corp.

General Re Financial Products Corp.

Generale Bank

GiroCredit Bank AG der Sparkassen

Goldman Sachs & Co.

Halifax plc

Hambros Bank Ltd.

Hamburgische Landesbank Gironzentrale

HSBC Midland

IBJ International Limited

IKB Deutsche Industriebank AG

IMI SIGECO Societe Intermed. Mobiliare S.p.A.

INA SIM S.p.A.

Industrial Bank of Japan, Limited

ING Bank

ING Baring Financial Products

Intercapital Brokers Ltd.

Investec Bank Limited

Istituto Bancario San Paolo di Torino

J. Henry Schroder & Co. Limited

J.P. Morgan Securities Ltd.

Joyo Bank, Ltd.

Keybank National Association

Kredietbank N.V.

Landesbank Hessen - Thueringen Girozentrale

Landesbank Rheinland-Pfalz Girozentrale

Landesbank Sachsen Girozentrale

Landesbank Schleswig-Holstein Girozentrale

Landesgirokasse offentliche Bank und Landessparkasse

Lehman Brothers

Lloyds Bank Plc

Long-Term Credit Bank of Japan

Maple Partners Bankhaus GmbH

MeesPierson, N.V.

Mellon Bank, N.A.

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Mitsubishi Trust and Banking Corp.

Mitsui Bussan Commodities Limited

Mitsui Trust & Banking Co. Ltd.

Morgan Stanley & Co. Inc.

National Australia Bank Limited

National Bank of Canada

National Bank of Greece

Nationale Investeringsbank N.V.

NationsBank

NatWest Capital Markets Limited

Nedcor Bank Limited

New Japan Securities Co., Ltd.

Nikko Securities Co., Ltd.

Nippon Credit Bank Ltd.

Nomura Capital Services Inc.

Nordbanken

Norddeutsche Landesbank Girozentrale

Norinchukin Bank

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Polish Development Bank

Prebon Yamane USA Inc.

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Sal. Oppenheim jr. & Cie KGaA

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Societe Generale

Standard Chartered Bank

Standard Corporate and Merchant Bank

Sudwestdeutsche Landesbank

Suedwestdeutsche Genossenschafts-Zentralbank AG

Sumitomo Bank Capital Markets, Inc.

Sumitomo Bank Ltd.

Sumitomo Trust and Banking Co., Ltd.

Suntrust Capital Markets, Inc.

Svenska Handelsbanken (Handelsbanken Markets)

SwedBank

Swiss Re Financial Products

Tokai Bank Ltd.

Tokyo-Mitsubishi International Plc

Toronto Dominion Bank

Toyo Trust and Banking Company, Limtied

Tradition-Berisford LP

Trinkaus & Burkhardt KGaA

Unibank A/S

Union Bank of Switzerland

Westdeutsche Genossenschafts-Zentralbank eG

Westdeutsche Landesbank Girozentrale

Westpac Banking Corporation

Yasuda Trust & Banking Co., Ltd.

Zurich Capital Markets

TOTAL PRIMARY MEMBERS: 197

ISDA ASSOCIATE MEMBERS

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Arthur Andersen & Co.

Arthur Cox Solicitors

Baker & McKenzie

Blake, Cassels/Lavery de Billy

Bloomberg Financial Markets

Brown & Wood

Buruma Maris

C-ATS Software Inc.

Cadwalader, Wickersham & Taft

Capital Market Risk Advisors, Inc.

Cedel

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Cleary, Gottleib, Steen & Hamilton

Clifford Chance

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De Brauw Blackstone Westbroek

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Deloitte & Touche

Denton Hall

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Dewey Ballantine

Documentum

Ernst & Young LLP

Euroclear

Field Fisher Waterhouse

Finnish Bankers Association

FNX Limited

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Front Capital Systems AB

Gide Loyrette Nouel

GovPX

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Harney Westwood & Riegels

Herbert Smith

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IBM

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Integral Development Corporation

Intuitive Products International Corp.

ITS Trading Systems Limited

Jones, Day, Reavis & Pogue

KMV Corporation

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Latham & Watkins

LeBoeuf, Lamb, Greene & MacRae

Lee & Li

Liffe (London Int'l Fin. Futures & Options)

Linklaters & Paines

Login S.A.

Lombard Risk Systems Ltd.

London Clearing House Ltd.

Longview International

Lovell White Durrant

M A T I F

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Mitsui, Yasuda, Wani & Maeda

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Morgan, Lewis & Bockius

Murex International Software

Nauta Dutilh

Norton Rose

Ogilvy Renault

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Rolfe & Nolan

S.W.I.F.T. sc

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Sidley & Austin

Simmons & Simmons

Simpson Thacher & Bartlett

Skadden, Arps, Slate, Meagher & Flom

Slaughter and May

SNS Systems Inc.

Standard & Poor's

Stikeman, Elliott

Stroock & Stroock & Lavan

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Sullivan & Cromwell

Summit Systems Inc.

SunGard Capital Markets Inc.

Synamic Limited

Telerate Systems Inc./Dow Jones

Tory Tory DesLauriers & Binnington

Travers Smith Braithwaite

Watson, Farley & Williams

Weil Gotshal & Manges

White & Case

Wilde Sapte

Wilmer, Cutler & Pickering

TOTAL ASSOCIATE MEMBERS: 105

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AB Svensk Exportkredit

ABB Capital B.V.

African Development Bank

Alliance - Invest Co.

American Express Company

American Honda Finance Corporation

American Re

B. Metzler seel Sohn & Co. KGaA

Banc One Funds Management Company

Bank Nederlandse Gemeenten, nv

British Petroleum Company p.l.c.

Caisse Centrale Desjardins

Caisse Centrale Du Credit Immobilier de France

Cargill Financial Services Corporation

Council of Europe Social Development Fund

DePfa Bank (Deutsche Pfandbrief-Hypotheken)

Deutsche Bau- und Bodenbank

Deutsche Girozentrale - Deutsche Kommunalbank

Dow Chemical Company

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Eastern Power & Energy Trading Ltd.

El Paso Energy Marketing Company

Electricite de France

ISDA SUBSCRIBER MEMBERS

Eskom

EUROFIMA

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European Investment Bank

Export Development Corp.

Federal Home Loan Bank of Atlanta

Federal Home Loan Bank of Chicago

Federal Home Loan Bank of Dallas

Federal Home Loan Bank of Pittsburgh

Federal Home Loan Mortgage Corporation

Finnish Export Credit Ltd.

Ford Motor Credit Company

General Electric Capital Corporation

Hydro-Quebec

IBM International Treasury Services Company

Instituto de Gestao de Credito Publico

Int'l Bank for Reconstruction (World Bank)

Intel Corporation

John Nuveen & Co. Incorporated

Kingdom of Denmark

Kingdom of Sweden

Kreditanstalt Fur Wiederaufbau

Landesbank Saar Girozentrale

Landeskreditbank Baden-Wuerttemberg (L-Bank)

TOTAL ISDA MEMBERS: 373

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July 28, 1998

Statement Submitted on Behalf of
The International Swaps and Derivatives Association, Inc.
To the Committee on Agriculture, Nutrition, and Forestry
United States Senate

This statement is submitted by the International Swaps and Derivatives Association, Inc. ("ISDA") to the United States Senate Committee on Agriculture, Nutrition, and Forestry (the "Committee") in connection with the Committee's July 30, 1998 hearing on privately-negotiated swap transactions and related activities.

ISDA is an international organization whose membership comprises 350 of the world's largest commercial, merchant and investment banks and other corporations and institutions that conduct significant activities in swaps and other privately negotiated derivatives transactions (collectively, "swap transactions"). The issues to be addressed in the Committee's hearing are of great importance to ISDA's members.

ISDA welcomes the Committee's invitation to testify. In recent months, ISDA has been active, together with industry groups, companies, financial institutions and other interested parties, in alerting the Commodity Futures Trading Commission (the "CFTC"), other agencies in the President's Working Group on Financial Markets and members of Congress to the serious implications that the CFTC's recent, unilateral actions have for United States financial markets and the reputation of those markets for legal certainty and financial innovation.

ISDA has been particularly concerned with the legal uncertainties relating to the status of swap transactions under the Commodity Exchange Act (the "CEA"), and believes that legislation should be enacted to clarify their status. Privately negotiated swaps and related off-exchange transactions serve important economic and risk management functions. Swap transactions are custom-tailored to meet the unique needs of individual firms. Due to the tailored nature of such transactions, swap transactions differ substantially from the standardized exchange-traded futures contracts governed by the CEA. As a result, swap transactions cannot fit within the regulatory framework defined by the CEA. In fact, the CEA is an inappropriate framework for the regulation of swap activity to such an extent that, if that framework were imposed on these contracts, the exchange trading requirement of the CEA would instantly call into question the enforceability of thousands of swap transactions and put at risk tens of billions of dollars of value on the books of American banks, brokers and corporations.

Historically, the CFTC has recognized this fact, and acted to make it clear that swap transactions are not appropriately regulated under the CEA, by issuing its 1989 Swaps Policy Statement and 1993 Swaps Exemption, which are discussed in detail below. Nevertheless, and despite significant efforts by Congress, the inapplicability of the CEA to these transactions has not been fully and adequately clarified. ISDA has actively supported the Committee in its efforts to resolve these uncertainties by modernizing the CEA.

Now the CFTC has reversed course. In a recent comment letter to the Securities and Exchange Commission on a new category of limited purpose securities dealer (or "broker-dealer lite"), in its interim final rule on agricultural trade options, and in its concept release on off-exchange derivatives, the CFTC has taken three major steps away from the goal that Congress, the CFTC and the industry have worked toward. These actions are harmful and increase legal uncertainty regardless of the motivation of the CFTC in taking these actions. Many parties, our members among them, are extremely concerned about the regulatory actions the CFTC has taken. We wholeheartedly support efforts to forestall actions by the CFTC in order to give Congress adequate time to weigh these important issues.

I. Importance of Swap Transactions

Many corporations, financial institutions and government entities in the United States rely on swap transactions to manage risk. Ordinary financial and commercial activities of these firms give rise to a host of risks, many of which could not be hedged or managed in an efficient manner, if at all, without the use of swap transactions. Therefore, the availability of swap transactions at low cost and within a strong legal framework in the United States is of vital interest to all ISDA members and the other institutions who rely on swap transactions. Any legal uncertainty presents a significant source of risk to individual institutions and to the financial markets as a whole and precludes the full realization of the powerful benefits such transactions provide.

Derivatives, particularly privately negotiated swaps, are powerful tools which allow the counterparties to adjust the risk characteristics of their assets and liabilities, fine tune their risk exposures and lower their costs of capital. In such a transaction, two counterparties establish a custom-tailored bilateral agreement to exchange cash flows at periodic intervals during the life of the deal according to a prearranged formula. These cash flows are determined by applying the prearranged formula to the "notional" principal amount of the swap transactions. In most swaps, such as interest rate swaps, this notional amount never changes hands and is merely used as a reference for calculating the future cash flows.

For example, if a corporation has floating-rate debt outstanding and is concerned that interest rates might rise, it could use an interest rate swap to convert its floating-rate debt into a fixed-rate obligation. Similarly, if a corporation earns non-dollar revenues from a foreign subsidiary and wants to avoid the risk of fluctuating exchange rates, it could use a currency swap to hedge this exposure. Almost any kind of swap can be created. The flexibility and benefits that swap transactions provide have led to dramatic growth in the use of such transactions. In addition to interest rate and currency swap transactions, commodity, equity, credit and other types of swap transactions are widely used. Transactions take place around the globe, and U.S. institutions are leaders in this business at home and abroad.

II. Introduction to the Problems

One of ISDA's main goals since its inception has been to promote legal certainty for swap transactions. ISDA has sought to establish (i) clarity concerning how swap transactions will be treated under U.S. law and laws in other jurisdictions, (ii) certainty that they will be legally enforceable and not subject to avoidance and (iii) certainty that key provisions in swap transactions (including termination and netting provisions) will be enforceable, even in the case of bankruptcy of one of the parties. For example, ISDA has worked with the Congress to pass legislation establishing the enforceability of master agreement netting provisions in the case of insolvency of a U.S. counterparty. In addition, ISDA has developed model swap contracts that are used in the United States and around the world by the vast majority of swap participants for their transactions.

The CFTC's recent actions are reminiscent of previous events that have cast doubt on the legal certainty that the CEA does not apply to swap transactions. That legal certainty has been undermined on several occasions in the past decade by the structure of the CEA, which bans off-exchange "futures" contracts without defining the term. The statute has not easily accommodated the great innovations in financial products that have taken place since the enactment of the CEA. In 1974, Congress excluded from the CEA certain wholesale privately negotiated transactions that might otherwise have been thought to be futures. However, at that time, swap transactions did not yet exist and therefore were not specifically excluded. The resulting legal uncertainties, which will be explained in more detail below, have inhibited the evolution of swap transactions in the United States and the natural and beneficial growth in their use.

III. History of CEA's Relationship to Swap Transactions

In 1922, Congress enacted the original version of what is now the CEA to protect farmers and other producers and merchants of certain agricultural commodities from the perceived abuses of futures contracts. The protective scheme mandated that all trading of futures contracts on certain commodities be regulated by the Department of Agriculture and conducted on organized futures exchanges (the "exchange trading requirement").1/ During the period from 1936 to 1974, the list of covered commodities was expanded periodically.

The statute was substantially revised in 1974 by (i) establishing the CFTC to administer the CEA and regulate U.S. commodities exchanges, (ii) expanding the definition of "commodity" to cover (with certain exceptions) "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt with"2/ and (iii) providing a statutory exclusion from the CEA for "transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade" (the "Treasury Amendment").3/

In the 1980's, the rapid growth in the use of innovative interest rate and currency swaps as well as related privately negotiated derivatives transactions to manage financial risk brought with it a desire to ensure a clear and unambiguous legal status for these transactions. In 1987, these legal concerns were significantly heightened when it was widely reported that the CFTC had commenced a formal investigation into the commodity swap business of Chase Manhattan Bank. Despite the fact that no enforcement action was ever commenced, these reports alone created significant

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1/ Before trading in a particular contract may lawfully occur, an exchange must apply for and receive "designation" as a "contract market" for the trading of a particular product. However, certain exceptions to the exchange trading requirement and other provisions of the CEA exist, such as the forward contract exclusion. Considerable litigation has resulted over what transactions Congress intended to cover with this exclusion.

2/ 7 U.S.C. § 2, CEA § 1(a)(3).

3/ 7 U.S.C. § 2(ii), CEA § 2(a)(1)(A)(ii).

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uncertainty regarding the status of swap transactions under the CEA. It was feared that swap transactions would be deemed to be illegal and unenforceable off-exchange futures contracts. This uncertainty was exacerbated when the CFTC issued an Advance Notice of Proposed Rulemaking in which it effectively stated that transactions such as swaps which include certain elements of futures contracts may be subject to the CEA.4/ In response to these concerns, large segments of U.S. swap activity moved offshore, and some U.S. firms ceased development of swaps entirely, reducing the ability of U.S. firms to manage risk and inhibiting the growth of these activities at U.S. institutions.

These events prompted ISDA and other industry participants to seek action by the CFTC to reduce the substantial legal uncertainty which resulted from these developments. To address these concerns, in 1989 the CFTC issued a policy statement (the "Swaps Policy Statement") stating its view "that at this time most swap transactions, although possessing elements of futures or options contracts, ***are not appropriately regulated as such under the [CEA] and regulations*** [emphasis added]".5/ Thus, a nonexclusive "safe harbor" was extended by the CFTC to those swap transactions that met a series of tests intended to distinguish them from their exchange-traded counterparts.6/ However, the Swaps Policy Statement did not explicitly include interest rate option products. The application of the Swaps Policy Statement to interest rate caps, floors and collars was subsequently clarified in a series of no-action letters. These events were welcomed in the marketplace, and swap transaction activity expanded substantially in subsequent years. However, legal uncertainties relating to the applicability of the CEA to swap transactions remained.

These uncertainties were further heightened in 1990 as the result of a decision by a United States District Court in New York in Transnor v. BP America Petroleum, which determined that contracts for future delivery of Brent blend crude oil constituted futures contracts and were therefore subject to the CEA.7/ Although swap transactions were not at issue in Transnor, it was feared that if another court were to apply to swap transactions Transnor's limited view of the forward contract exclusion and its expansive definition of a futures contract, and at the same time were to ignore the Swaps Policy Statement, such a court might determine that certain swap transactions were futures contracts under the CEA. The importance and potential consequences of legal risks applicable to swap transactions were subsequently brought to light in 1991 when the London Borough of Hammersmith and Fulham, which had repudiated numerous losses from swap contracts, was able to convince the House of Lords (England's highest court) that it was *ultra vires* to have entered into the contracts in the first instance, thereby voiding the contracts. Concern increased that similar losses could be realized in the U.S. as a result of ambiguities under the CEA.

4/ 52 Fed. Reg. 47022 (Dec. 11, 1987).

5/ 54 Fed. Reg. 30694 (July 21, 1989).

6/ In order to qualify for the nonexclusive safe harbor under the Swaps Policy Statement, swap transactions, among other things, must (i) reflect individually-tailored terms based upon individualized credit determination, (ii) lack an exchange-style offset, (iii) lack a clearing organization or margin system, (iv) be undertaken in conjunction with a line of business and (v) not be marketed to the general public.

7/ 738 F. Supp. 1497. Since the Brent contracts in question were routinely settled without physical delivery by means of certain offset techniques, the court concluded that Brent contracts did not qualify for the forward contract exclusion, and then went on to determine that they were futures contracts.

In 1992, Congress took a major step to provide legal certainty that the CEA was not generally applicable to swap transactions by passing the Futures Trading Practices Act of 1992 (the "FTPA"). The FTPA provided the CFTC with the power to create exemptions from the CEA for futures contracts and transactions with futures-like elements. The Report of the Committee of Conference of the U.S. House of Representatives and the U.S. Senate for the FTPA (the "Conference Report") stated that the intent of this authority was "to give the [CFTC] a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner".8/ In passing the FTPA, Congress specifically directed the CFTC to resolve legal uncertainty concerns by promulgating an exemption for swaps and certain hybrid contracts. In order to avoid any implication that swaps are futures, Congress expressly noted in the Conference Report that the granting of an exemption does not "require any determination beforehand that the agreement, instrument or transaction for which an exemption is sought is subject to the [CEA]".9/

In response to the FTPA, the CFTC adopted an exemption for "swap agreements" in January 1993 (the "Swaps Exemption").10/ Reflecting Congress' direction in the FTPA, the CFTC did not make any determination that swap agreements would otherwise be subject to the CEA. The Swaps Exemption exempted certain types of swap transactions, when entered into by "eligible swap participants", from selected provisions of the CEA, including the exchange-trading requirement.11/ Exempted transactions still must meet certain criteria that are intended to distinguish them from exchange-traded agreements.12/ In general, the Swaps Exemption covers a broader range of swap transactions than does the Swaps Policy Statement.

As a result of the Swaps Exemption, even if a swap were found to be a futures contract, and none has, it would only be subject to (i) the market manipulation and anti-fraud provisions of the CEA and (ii) Section 2(a)(1)(B) of the CEA, which was enacted pursuant to the Futures Trading Act of 1982, otherwise known as the Shad-Johnson jurisdictional accord (the "Jurisdictional Accord"), and which (A) divides jurisdiction over exchange-traded derivative transactions on securities between the Securities and Exchange Commission (the "SEC") and the CFTC, and (B) establishes that futures contracts on individual securities and certain narrow securities indices are illegal.

8/ H.R. Rep. No. 978, 102d Cong., 2d Sess. at 81 (1992).

9/ Id.

10/ 58 Fed. Reg. 5587 (Jan. 22, 1993).

11/ Eligible swap participants include: banks and trust companies; saving associations and credit unions; insurance companies; commodity pools having assets exceeding $5,000,000 and meeting certain other criteria; broker-dealers; futures commission merchants; certain employee benefit plans with total assets exceeding $5,000,000; governmental entities; natural persons with total assets exceeding $10,000,000; and corporations, partnerships, trusts or other entities that satisfy certain criteria.

12/ Such transactions, among other things, must (i) not be part of a fungible class of agreements that are standardized as to their material economic terms, (ii) involve individualized creditworthiness determinations, and (iii) not be traded on or through a multilateral execution facility.

Also in January 1993, the CFTC adopted an exemptive framework for certain hybrid instruments, which provides an exemption for instruments such as equity or debt securities or depository instruments with imbedded futures or commodity option characteristics. If applicable, the exemption extends to all provisions of the CEA except the provisions adopted pursuant to the Jurisdictional Accord. Other relevant exemptions which exist include those granted for (i) certain contracts for the deferred purchase or sale of specified energy products entered into between commercial participants meeting certain criteria and (ii) trade options sold to commercial counterparties who are entering into a transaction for purposes related to their business.

IV. Swaps Differ from Futures

The importance of swap transactions to global commerce and finance has been well-documented. Careful tailoring of the nature, timing and amount of a transaction can insulate a swap participant from adverse movements in market prices, reduce its cost of capital or allow it to take a view on market changes. Efficiency gains are created when risks are shifted to those best able to bear them.

These useful transactions, as the Conference Report noted, "may contain some features similar to those of regulated exchange-traded products but are sufficiently different in their purpose, function, design or other characteristics that, as a matter of policy, traditional futures regulation and the limitation of trading to the floor of an exchange may be unnecessary to protect the public interest and may create an inappropriate burden on commerce".13/ Section 3 of the CEA describes the necessity for regulation of "[t]ransactions in commodities . . . [that] are carried on in large volume by the public generally and by persons engaged in the business of buying and selling commodities and the . . . byproducts thereof in interstate commerce". Section 3 notes that such " . . . transactions and prices of commodities on such boards of trade are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed, to the detriment of the producer or the consumer . . . rendering regulation imperative for the protection of [interstate] commerce and the national public interest therein".

Several factors clearly differentiate swap transactions from the transactions regulated under the CEA. First, such transactions are not "carried on in large volume by the public generally". Swap transactions are entered into on a customized, privately negotiated basis by sophisticated parties, including governments and government-sponsored entities, commercial and investment banks, corporations, and, to a very limited extent, certain individuals. Second, swap transactions are transactions in which each party assumes the credit risk of the other and thus each party requires specific knowledge about the other. The limits set forth in the Swaps Exemption preclude transactions that are standardized and fungible, i.e., transactions that are capable of being traded in large volumes. In addition, since such transactions are not standardized and fungible, they are simply not capable of being systematically traded on the floor of an exchange.

The exemption of swap transactions from the CEA has achieved the objective of Congress, promoting economic and financial innovation and fair competition. As stated earlier, swap transactions are used today by a large variety of entities to manage financial risks and develop new opportunities to raise capital. The growth of swap activities has been fueled by demand from these entities for new structures and refinements to address their diverse needs and the ability of swap intermediaries to develop transactions which meet those needs efficiently.

13/ H.R. Rep. No. 978, 102d Cong., 2d Sess. 80 (1992).

V. Continuing Legal Uncertainties

Despite the efforts referred to above and the related subsequent legislative and regulatory pronouncements, there continue to be concerns about the legal uncertainty with respect to the inapplicability of the CEA to swap transactions. The first stems from the very nature of the Swaps Exemption as an administrative pronouncement that can be revoked or modified by the CFTC. The recent CFTC actions are evidence that this is a real concern. This leaves open the possibility that direct regulation will be imposed over swap transactions; rendering them illegal except when traded on an organized exchange and enabling parties to privately negotiated derivatives transactions to seek to avoid their contractual obligations by asserting that the transactions are illegal unless they either conform to any new or changed conditions added to the Swaps Exemption by the CFTC or are traded on an organized exchange. This could result in substantial losses to swap participants, including the loss of hedges which companies rely on to manage risk. We have previously testified before this Committee that even the potential for such action could cause disruption to the financial markets. Unless Congress acts, the CFTC's recent actions are likely to have this effect.

Second, the various exemptions from the CEA applicable to swaps have stated that swaps are not "appropriately regulated" as futures under the CEA. However, they have not established with the force of statute that swaps are not futures. Therefore, problems could arise inadvertently, as the CFTC exercises its enforcement authority. The July 1995 enforcement proceeding against MG Refining and Marketing, Inc. and MG Futures, Inc. (the "MG Enforcement Order") raised such concerns. In the MG Enforcement Order, the CFTC took the opportunity to define "all the essential elements of a futures contract" in a way which was so broad as to encompass practically any privately negotiated cash-settled forward contract, including most swap transactions. Although the CFTC sought on two separate occasions to reassure key members of Congress and industry participants that its orders in these cases were not intended to, and did not, change the scope of the term "futures contract" under the CEA, MG Refining and Marketing, Inc. and MG Futures, Inc. are attempting to use the Enforcement Order to avoid their obligations under unprofitable transactions in pending litigation. This is an example of the negative impact legal uncertainty can have with respect to undermining the enforceability of swap transactions. Problems like this highlight the fact that the current structure of the CEA is inadequate to provide the requisite degree of legal certainty to swap participants. Repeated episodes of similar events, such as the CFTC's recent actions, may lead some to conclude that the United States lacks a sufficiently stable legal framework to continue to function as a center for swap transactions. In fact, the United States has become such a center as a result of the establishment of legal certainty with respect to other aspects of swap transactions, such as the enforceability of master agreement netting provisions in the case of insolvency of a U.S. counterparty.

The possibility that some or a substantial category of privately negotiated derivatives transactions may be interpreted, even inadvertently, to be futures contracts also raises serious concerns with respect to those transactions falling outside the scope of the current or a future revised Swaps Exemption, particularly equity swaps and other swaps based on the prices of securities.

VI. Legal Uncertainties Relating to Privately Negotiated Swap Transactions Involving Securities Prices

Legal uncertainty is particularly acute with respect to privately negotiated equity derivatives, such as equity swaps. As discussed above, the CEA prohibits the entering into of futures contracts, unless made on or subject to the rules of an approved futures exchange. Therefore, any financial transaction that is a futures contract must either be (i) transacted on an approved board of trade or (ii) exempted from the exchange trading requirement by the CFTC. The CFTC has the power to exempt certain types of financial transactions from the requirements of the CEA under the FTPA, and promulgated the Swaps Exemption based on this authority. The FTPA, however, limits the exemptive authority of the CFTC by prohibiting the CFTC from exempting any futures contracts from the provisions of the Jurisdictional Accord.

Pursuant to the Jurisdictional Accord, the CFTC may not designate a board of trade for futures contracts on individual securities and certain narrowly defined securities indices, and since the CFTC can not issue an exemption for such futures contracts, such futures contracts are essentially illegal. Under the Jurisdictional Accord, the CFTC and SEC were granted jurisdiction, respectively, over futures and securities; futures contracts based on a group or index of securities are treated like other futures contracts under the jurisdiction of the CFTC (i.e., they must be traded on an exchange) and jurisdiction over options on individual securities was granted exclusively to the SEC. As a result, the Swaps Exemption does not cover transactions that are proscribed by the Jurisdictional Accord, and the conclusion that those transactions will not be regulated as futures must instead rest on the Swaps Policy Statement, which provides comfort that transactions within its limit are not "appropriately regulated" as futures contracts. To the extent, however, that swaps ever are deemed to be futures contracts, even inadvertently, (i) swaps on single securities and certain narrow indices or groups of securities would be rendered illegal under the Jurisdictional Accord and (ii) swaps on broad-based groups or indices would be required to be traded on an approved board of trade, which in each case would render a privately negotiated transaction pertaining to such securities, groups of securities or indices, as the case may be, subject to challenge by the parties to the transaction as unenforceable. Such risks have led many participants to enter into such swap transactions on securities prices through off-shore affiliates.

VII. Legal Uncertainty Relating to Certain Foreign Currency Transactions

The Treasury Amendment, which excludes certain foreign exchange transactions from the CEA, is statutory in nature and broader in scope than the Swaps Exemption. Therefore, unlike the Swaps Exemption, the Treasury Amendment may not be revoked or modified by the CFTC and creates a statutory exclusion from the CEA for the transactions to which it applies.

Nevertheless, a tremendous amount of litigation has arisen with respect to the scope of the Treasury Amendment. Without limiting its benefits to certain classes of participants, the Treasury Amendment excludes from the scope of the CEA "transactions in foreign currency . . . unless such transactions involve the sale thereof for future delivery conducted on a board of trade".14/ Ambiguity existed over the potential difference between transactions "in" foreign currency and transactions "involving" foreign currency, giving rise to potential legal concerns, but was settled in Dunn v. CFTC.15/ However, the meaning of the term "board of trade" continues to give rise to potential legal concerns.16/

14/ 7 U.S.C. § 2, CEA § 1(a)(3).

15/ 117 S. Ct. 913 (1997)

16/ In Salomon Forex Inc. v. Tauber, 8 F.3d 966, the United States Court of Appeals for the Fourth Circuit construed the "Treasury Amendment exempting transactions in foreign currency to reach beyond transactions in the commodity itself and to include all transactions in which foreign currency is the subject matter, including futures and options." Id. at 975. This reasoning was subsequently supported by the United States Supreme Court in Dunn, 117 S. Ct. 913 (1997).

VIII. Events Since Last Year's Congressional Debate Over CEA Modernization

In 1996 bills were introduced in both the House and the Senate that, to varying degrees, sought to remedy the fundamental flaws in the CEA. ISDA testified before this Committee and before the Senate Agriculture, Nutrition and Forestry Committee on the need to modernize the CEA. These bills were debated at length, and that debate addressed a wide range of concerns. However, because the debate was not triggered by the assertion of jurisdiction by one agency acting under a flawed statute, the legal certainty that existed for these risk management transactions was not adversely affected by the legislative process, and there was no effect on their availability to the corporations, financial instruments and government entities that rely on them.

Recent Actions by the CFTC. Users of privately negotiated swaps have continued to rely on the proven structure established by the Swaps Policy Statement, the FTPA, the Swaps Exemption and the hybrid exemption. As the hearings by this Committee last year indicated, there is a critical need to modernize the CEA and thereby provide greater legal certainty that privately negotiated swaps are not subject to the CEA. Until that goal is achieved, however, the existing exemptions provide a significant degree of legal certainty for these instruments, barring any further statements or actions by the CFTC.

The imperfect, but workable, structure established by Congress in 1992 and the CFTC in 1993 was shaken this year by a series of CFTC actions. Through comments, public statements and official actions, the CFTC has undermined the carefully crafted legal certainty that these instruments currently enjoy. Taken together, these actions and statements indicate a troubling shift in CFTC policy that is contrary to the express intent of Congress when it enacted the FTPA. Once again, we are faced with a situation that could have been avoided if the CEA were modernized to reflect the unique nature of these privately negotiated transactions.

Broker-Dealer Lite Comment Letter. The first indication of this significant shift in CFTC policy was the comment letter it filed on the SEC's proposal to establish a special category of limited purpose securities dealers specializing in privately negotiated derivatives. The most explicit formulation of this change in policy was an assertion in the CFTC's comment letter, supported in neither law nor fact, that many swaps constitute futures. The tone throughout the letter was that jurisdiction over swaps was being wrested from the CFTC by the SEC. This tone ignored the fact that neither Congress nor the CFTC has ever determined that swaps were subject to CFTC jurisdiction or that swaps are futures. In its comment letter, the CFTC first hinted that it intended to issue a concept release in which it would review developments since its 1993 exemptions for swaps and hybrids.

Agricultural Trade Options. The next indication that the CFTC was staking out new policy ground has not received as much attention as its broker-dealer lite comment letter or the more recent concept release, but it is perhaps the clearest example of the broad implications that CFTC actions can have on the availability of these important risk management instruments. As part of a comprehensive review of its regulations, the CFTC considered the loosening of its previous prohibition on off-exchange agricultural trade options. Following the same path on which it is embarking on swap transactions, it issued a concept release seeking input on how it should proceed. ISDA, together with many interested parties from the agricultural community, followed this proposal closely and commented at various stages. ISDA's particular interest was to ensure that the loosening of restrictions on agricultural trade options was not done at the expense of the Swap Exemption, and we filed a comment letter to that effect. Others, including the National Grain and Feed Association, shared that view.

In recently adopting an interim final rule on agricultural trade options,17/ the CFTC has given little with one hand and taken much with the other. While off-exchange agricultural trade options are no longer prohibited, they can only be entered into pursuant to a cumbersome and costly regulatory regime. What is worse, the CFTC reduced the scope of the Swaps Exemption, reduced the availability of hedges for agricultural commodities and increased regulatory burdens by asserting that the provisions of the Swaps Exemption are no longer available for commodity swaps involving agricultural commodities. This is in direct contradiction to the explicit provisions of the Swaps Exemption and the accepted market practice of those who rely on swaps to manage their exposure to agricultural commodity price fluctuations. The CFTC has unilaterally prohibited a significant portion of the commodity swap business. Dealers in and users of these hedges of agricultural price risk have already curtailed their activity in this area in response to this interim final rule. Those who seek insight into where the CFTC may be going with its concept release on swap transactions need look no further than its approach to the agricultural trade option issue.

Concept Release on Swap Transactions. The CFTC's shift in policy culminated in the issuance of its extensive concept release on swap transactions.18/ The concept release is cast as merely an information gathering effort, yet given the extensive debate in Congress in the last two years and the October 1997 report of the General Accounting Office (the "GAO Report"), it is hard to imagine that the CFTC did not have access to adequate information on swap transactions. In fact, the concept release lays out a broad regulatory scheme that confirms the CFTC's true objective: unilaterally declaring itself the functional regulator of swaps and hybrids to the exclusion of other agencies and against the express will of Congress.

ISDA shares the concerns expressed by Treasury Secretary Rubin, Federal Reserve Board Chairman Greenspan and SEC Chairman Levitt at the time the concept release was issued and in their letter transmitting their recent proposed legislation to Congress. ISDA believes that the CFTC's actions, if left unchecked, will have serious ramifications for the availability and cost-effectiveness of these risk management instruments for American corporations, financial institutions and government-sponsored enterprises that need to manage the risks inherent in their daily business operations. Moreover, the course of action on which the CFTC has embarked will adversely affect the ability of firms to conduct their swap and hybrid business in the United States. These problems will only increase if the CFTC proceeds to the rule-making stage.

On one level the concept release is just a series of questions, ranging from the general to the specific, from the simple to the complex. Yet, long before a reader of the release gets to any questions, it is clear that the CFTC is asserting its view that swap transactions are subject to CFTC regulation. Early in the release the CFTC states: "The purpose of this release is to solicit comments on whether **the regulatory structure applicable to OTC derivatives under the Commission's regulations** should be modified in any way...." (emphasis added). To those of us who have followed these issues so closely in recent years, statements such as these cause serious concern about a fundamental shift in CFTC policy. We fear a repeat of the experiences described earlier in this statement, where business was curtailed or moved offshore in the face of assertions of CFTC jurisdiction.

The jurisdictional assertions in the concept release are contrary to well-established CFTC policy and are inconsistent with the position that Congress took in the FTPA. The dangerous

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17/ 63 Fed. Reg. 18821 (April 16, 1998)

18/ 63 Fed. Reg. 26114 (May 12, 1998)

consequences of these assertions were undoubtedly among the reasons that Secretary Rubin, Chairman Greenspan and SEC Chairman Levitt responded immediately to the concept release and expressed their "grave concern" about the CFTC's actions in issuing the concept release. The CFTC is moving forward with its regulatory review of swap transactions without any mandate in the CEA or from Congress to undertake that review.

The CFTC cites recent losses from the use of these instruments as one of its principal justifications for commencing its review of privately negotiated swaps. Yet many of the incidents referred to in the concept release involve investments in securities or other financial transactions not swap transactions. The GAO Report19/, which the CFTC relies on for much of its alleged evidence of losses, specifically determined that the level of losses identified did not justify additional regulatory action.

There is simply no evidence of a failure of these transactions to fulfill their intended purpose: to enable users to manage their business risk better, with greater flexibility and at a lower cost. By focusing narrowly on perceived "losses" on these instruments, divorced from their underlying purpose to permit companies to mitigate risk, the CFTC's view of these transactions will inevitably be distorted. It would be equally distortive to focus on "gains" from these transactions. Focusing on "gains" or "losses" ignores the dynamic purpose that these instruments achieve through facilitating more prudent risk management. The gains from these instruments are the ways they have expanded the ability of corporations, financial institutions and government entities to manage their financial, business and other risks more effectively. On this score the gains have been significant.

The CFTC also cites the "explosive growth" in the use of swap transactions and related instruments as a reason for undertaking its regulatory review. It is difficult to see how growth, which is generally evidence of success, could justify the extensive review the CFTC has undertaken. The volume of any product, including swaps, can only increase where there is a demand for the product. The growth in the use of swaps is a direct result of the growing demand in all sectors of the economy -- financial, industrial, agricultural and service-related -- for tools that facilitate more efficient and cost-effective risk management and permit companies to focus on their core businesses. The increased volume of swap transactions and related instruments is evidence that these instruments respond to that demand. ISDA includes among its members many corporations and government-sponsored entities that rely on these instruments to manage the risks in their business, and, like ISDA's dealer members, they are concerned about the adverse effect that the CFTC's actions may have on the availability and cost of these instruments.

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Legal uncertainty and fear of CFTC action will have severe consequences. This uncertainty threatens the stability of the financial markets and the competitive position of the United States as a financial center. Accordingly, the CFTC must be prevented from acting until Congress has had an opportunity to weigh these important issues.

ISDA appreciates this opportunity to express its views regarding these important issues and would invite any further inquiries from the Committee. If you should have any questions or comments, please feel free to contact any members of the ISDA Board of Directors listed in Annex A.

19/ General Accounting Office, GAO/GGD-98-5, "OTC Derivatives: Additional Oversight Could Reduce Costly Sales Practice Disputes".

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