

**PREPARED STATEMENT OF THE  
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.  
BEFORE THE  
COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY  
UNITED STATES SENATE  
JULY 10, 2002**

**Overview**

ISDA is an international organization, and its more than 575 members include the world's leading dealers in OTC derivatives as well as many of the businesses, financial institutions, governmental entities, and other end users that rely on OTC derivatives to manage the financial and commodity market risks inherent in their economic activities with a degree of efficiency and effectiveness that would not otherwise be possible.

ISDA is pleased to be here today to discuss the existing regulatory authority of the Commodity Futures Trading Commission (CFTC) over swaps and other privately-negotiated derivatives transactions (OTC derivatives) and proposals to amend the Commodity Exchange Act (CEA) to increase the CFTC's authority over these transactions. ISDA believes a rewrite of the Commodity Futures Modernization Act of 2000 (CFMA) is unjustified and that events relating to Enron's collapse do not demonstrate a need for regulation of OTC derivatives.

The current framework for the CFTC's regulatory authority is set forth in the CFMA, which was adopted by Congress with broad bipartisan support after careful consideration over several years by four Congressional Committees, including this Committee, and with the support of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the CFTC. The CFMA sought to

modernize the Commodity Exchange Act by addressing three main objectives; regulatory relief for the futures exchanges, legal certainty for OTC derivatives, and removal of the ban on single-stock futures trading. With respect to OTC derivatives, the CFMA framework is based on a long-standing consensus among Congress, the CFTC and others that such transactions generally are not appropriately regulated as futures contracts under the CEA. Historically, the CFTC has recognized this fact and has acted to assure that swap transactions are not regulated under the Commodity Exchange Act through issuance of the 1989 Swaps Policy Statement and the 1993 Swaps Exemption. As a result, careful scrutiny should be given to proposals to alter the basic provisions the CFMA applicable to OTC derivatives lest the underlying policy objectives of those provisions be unnecessarily compromised.

Some have suggested that the collapse of Enron Corporation justifies expanding the CFTC's jurisdiction with respect to OTC derivatives. As discussed elsewhere in this statement, ISDA does not believe that this is the case. Indeed, it appears that the legal certainty provisions of the CFMA and the related provisions of the Bankruptcy Code (adopted in 1990) may have enhanced the ability of market participants to deal effectively with events such as the collapse of Enron. The Enron failure demonstrated a failure of corporate governance, in which internal control mechanisms were short-circuited by conflicts of interest that enriched certain managers at the expense of the shareholders. Although Enron made use of OTC derivatives, there is no indication that OTC derivatives contributed in any significant way to Enron's collapse.

It has also been alleged that Enron and others engaged in transactions that were intended to manipulate the cash markets for electricity and natural gas in California and that these activities constitute an independent basis for expanding the CFTC's regulatory authority with respect to OTC derivatives. These allegations of manipulation are profoundly disturbing, and ISDA considers it prudent that the appropriate legislative bodies and regulatory authorities investigate them expeditiously and completely.

## Existing CFTC Regulatory Authority Concerning OTC Derivatives

### Importance of OTC Derivatives

OTC derivatives are powerful tools that enable financial institutions, businesses, governmental entities, and other end users to manage the financial, commodity, credit and other risks that are inherent in their core economic activities. In this way, businesses and other end users of OTC derivatives are able to lower their cost of capital, manage their credit exposures, and increase their competitiveness both in the United States and abroad. Almost all OTC derivatives transactions involve sophisticated counterparties, and, unlike the futures markets, there is virtually no “retail” market for these transactions.

The use of OTC derivatives is a positive force in the financial markets. As Federal Reserve Chairman Greenspan noted at a recent Senate Banking Committee hearing (March 7, 2002) “they (derivatives) are a major contributor to the flexibility and resiliency of our financial system. Because remember what derivatives do. They shift risk from those who are undesirous or incapable of absorbing it to those who are.” OTC derivatives are used to unbundle risks and transfer those risks to parties that are able and willing to accept them. 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 effectively convert its debt into a fixed rate obligation, thereby fixing its exposure. Similarly, if business has the right to receive non-dollar denominated revenues from a foreign-based affiliate, it could use a currency swap to hedge the risk of exposure to fluctuating exchange rates. This Committee has recognized that, as the result of OTC derivatives transactions such as these, “efficiency is enhanced as firms are better able to concentrate on their core economic objectives.” S. Rep. No. 106-390 at 2 (2000).

Swaps transactions are custom tailored to meet the unique needs of individual firms. Due to the tailored nature of such transactions, swaps differ substantially from the standardized exchange-traded futures contracts regulated by the CFTC. In a typical OTC derivatives transaction, two counterparties enter into an agreement to exchange

cash flows at periodic intervals during the term of the agreement. The cash flows are determined by applying a prearranged formula to the “notional” principal amount of the transaction. In most cases, such as interest rate swaps, this notional principal amount never changes hands and is merely used as a reference for calculating the cash flows. Almost any kind of OTC derivative can be created. The flexibility and benefits that these transactions provide have led to their dramatic growth. In addition to interest rate and currency transactions, commodity, equity, credit and other types of transactions are widely used. Transactions take place around the world, but the United States has been a leader in the development of OTC derivatives transactions, and American businesses were among the earliest to benefit from these risk management tools. The dramatic growth in the volume and diversity of OTC derivatives transactions is the best evidence of their importance to, and acceptance by, end users.

While its use is a matter of choice among the parties to the transaction, almost all OTC derivatives contracts both within and outside the United States are based on the 1992 Master Agreement published by ISDA. The ISDA Master Agreement is a standard form and governs the legal and credit relationship between counterparties, and incorporates counterparty risk mitigation practices such as netting and allows for collateralization. The ISDA Master Agreement also addresses issues related to bankruptcy and insolvency, such as netting, valuation and payment. The strength of the ISDA documentation and the important actions taken by Congress to ensure that OTC derivatives contracts would be enforceable in accordance with their terms have contributed positively to the ability of the financial and commodity markets to absorb events such as the Enron bankruptcy without systemic risk.

### **Legal Certainty and the CEA**

The availability of OTC derivatives transactions within a strong legal framework is of vital importance. Any uncertainty with respect to the enforceability of OTC derivatives contracts obviously presents a significant source of risk to individual parties to those specific transactions. Moreover, any legal uncertainty creates risks for the financial markets as a whole and precludes the full realization of the powerful risk management

benefits that OTC derivatives transactions provide. One of ISDA's principal goals since its inception has been to promote legal certainty for OTC derivatives transactions.

“Legal certainty” simply means that parties must be certain that the provisions of their OTC derivatives contracts will be enforceable in accordance with their terms. For example, ISDA has sought to establish (i) clarity concerning how OTC derivatives transactions will be treated under the laws and regulations of the United States as well as many other countries; (ii) certainty that OTC derivatives transactions will be legally enforceable in accordance with their terms and not subject to avoidance; and (iii) certainty that key provisions of OTC derivatives transactions (including netting and termination provisions) will be enforceable, even in the case of the bankruptcy of one of the parties.

Within the United States, until the adoption of the CFMA, the CEA was the major source of legal uncertainty with respect to OTC derivatives. As discussed below, both Congress and the CFTC have since the late 1980s acted to provide increased legal certainty for OTC derivatives.

The original version of what is now the CEA was enacted in 1922 to ensure that participants in the commodities futures markets were not defrauded and that those markets, which served significant price discovery functions, were not manipulated. To achieve these objectives, the CEA required, and still requires, that all futures contracts on covered commodities be traded on a government-regulated futures exchange. Under this “exchange-trading requirement”, all futures contracts that are not traded on a regulated futures exchange are illegal and unenforceable.

As originally enacted, the CEA applied only with respect to certain agricultural commodities. In 1974, the CEA was substantially revised by (i) establishing the CFTC as an independent agency to administer the CEA; (ii) expanding the definition of “commodity” to include (with certain exceptions) “all services, rights, and interests in which contracts for future delivery are presently or in the future dealt with”; and (iii) at

the request of the Treasury Department, providing a statutory exclusion from the CEA for transactions in or involving government securities, foreign currencies and certain other similar commodities.

**1989 Swaps Policy Statement.** In the late 1980s, the use of interest rate and currency swaps and other OTC derivatives transactions to manage financial risks grew rapidly. At this time, there was a consensus that OTC derivatives were not “futures” contracts. Nevertheless, because of certain perceived similarities between OTC derivatives and exchange traded futures contracts, there was residual concern that the CFTC or a court might treat OTC derivatives contracts as futures, which would render them illegal and unenforceable by reason of the CEA’s exchange trading requirement.

To address these concerns, the CFTC issued a Swaps Policy Statement in 1989 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. . . .” The CFTC also established a nonexclusive safe harbor for swaps transactions that met certain requirements (e.g., that they were undertaken in connection with a line of business and not marketed to the general public). The Swaps Policy Statement provided legal certainty that the CFTC would not initiate enforcement actions with respect to OTC derivatives that satisfied the safe harbor, but it did not and could not eliminate the risk that a counterparty to an OTC derivatives contract would attempt to avoid its contractual obligations by seeking a court ruling that the contract was an illegal off-exchange “futures” contract.

**Futures Trading Practices Act of 1992 (FTPA).** In 1992, Congress itself took a major step to provide legal certainty that the CEA was not applicable to OTC derivatives by passing the FTPA. In this important legislation Congress provided the CFTC with explicit statutory authority to issue exemptions from the CEA. The purpose of granting this exemptive 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.”

In passing the FTPA, Congress specifically directed the CFTC to resolve legal certainty concerns with respect to OTC derivatives by promulgating an exemption for swaps and certain hybrid contracts. In order to avoid any implication that any class of OTC derivatives transactions were “futures,” the Congress made it very clear that 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].”

**1993 CFTC Exemptions.** In response to the FTPA, the CFTC adopted a series of exemptions. In January 1993, the CFTC issued the Swaps Exemption and an exemption for hybrid instruments. The Swaps Exemption exempted certain types of OTC derivatives, when entered into between sophisticated counterparties, from most provisions of the CEA, including the exchange-trading requirement. In general, the Swaps Exemption covered a broader range of contracts than did the 1989 Swaps Policy Statement, but some types of OTC derivatives were not covered (e.g., other provisions of the CEA precluded application of the Swaps Exemption to OTC derivatives based on securities). In April 1993, the CFTC also issued an exemption for certain contracts involving specified energy products when entered into between commercial participants. This exemption, issued after notice and opportunity for public comment, was also intended to provide legal certainty that the covered energy contracts were not subject to regulation under the CEA.

**1998 CFTC Concept Release and Congressional Moratorium.** Despite these efforts by Congress and the CFTC to provide increased legal certainty that most OTC derivatives were not appropriately regulated as futures under the CEA, concerns continued to exist. These concerns proved to be neither academic nor speculative. In 1998, the CFTC issued a so-called “Concept Release” on OTC derivatives. As described by this Committee, the Concept Release

“. . . was perceived by many as foreshadowing possible regulation of these instruments [OTC derivatives] as futures. The possibility of regulatory action had considerable ramifications, given the size and importance of the OTC market. This action [by the CFTC] significantly magnified the long-standing legal uncertainty surrounding these instruments, raising concerns in the OTC market, including suggestions it would cause portions of the market to move overseas.

“This prospect led the Treasury, the Fed and the SEC to oppose the concept release and request that Congress enact a moratorium on the CFTC’s ability to regulate these instruments until after the [President’s] Working Group [on Financial Markets] could complete a study of the issue. As a result, Congress passed a six-month moratorium on the CFTC’s ability to regulate OTC derivatives.” S. Rep. No. 106-390 (2000).

**1999 President’s Working Group Report.** On November 15, 1999, the President’s Working Group on Financial Markets issued its report entitled *Over-the-Counter Derivatives Markets and the Commodity Exchange Act*. The Report reflected an extraordinary consensus reached by the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the CFTC. It recommended that Congress enact legislation explicitly to clarify that most OTC derivatives transactions involving financial commodities generally are excluded from the CEA. As stated in the Report, “. . . an environment of legal certainty . . . will help reduce systemic risk in the financial markets and enhance the competitiveness of the U.S. financial sector”. Indeed, as the Report also noted, the failure to enact such legislation “. . . would perpetuate legal uncertainty and impose unnecessary regulatory burdens and constraints upon the development of these markets within the United States”.

The report is available at: <http://www.ustreas.gov/press/releases/report3086.htm>

**Commodity Futures Modernization Act of 2000 (CFMA).** In December 2000, Congress passed the CFMA. This specific legislation was the product of more than two years of consideration. Four Committees of the Congress held hearings on and formally approved the legislation. At these hearings and elsewhere, key financial regulators (the Treasury, the Federal Reserve, the SEC and the CFTC) and other interested parties presented and debated the merits of various alternative proposals. At each stage of its consideration, bipartisan majorities approved the CFMA.

The principal purpose of the legislation was to eliminate, and not merely reduce, uncertainty with respect to the legal and regulatory status of most OTC derivatives

transactions involving sophisticated counterparties. In this respect, as demonstrated by the preceding discussion, the CFMA did not mark a radical departure from prior policy. For more than a decade prior to passage of the CFMA, Congress and the CFTC had worked diligently and almost without exception to provide increased legal certainty that OTC derivatives transactions were not appropriately regulated as futures contracts under the CEA. The CFMA is a culmination of a long and deliberate process to provide legal certainty for OTC derivatives and thereby reduce systemic risk and promote financial innovation. A detailed analysis of the CFMA is available on ISDA's web site: Comment Letters 1/5/2002: [www.isda.org](http://www.isda.org).

### **Proposals to Expand CFTC Authority**

In light of the foregoing history, careful scrutiny should be given to proposals to alter the basic and long-standing policy that underpins the provisions of the CFMA applicable to OTC derivatives; namely, that most such transactions are not appropriately regulated as futures under the CFMA. Although Congress adopted the CFMA less than two years ago, two subsequent events have prompted some to suggest that the CEA should be amended to provide increased regulation of OTC derivatives by the CFTC. These events are the collapse of Enron and the disclosure of transactions by Enron and others in or with respect to the California energy market. The most specific proposal for expansion of the CFTC's authority was contained in an amendment offered by Senator Feinstein and others to S. 517 earlier this year. As discussed below, ISDA joined with many organizations and firms in opposing the amendment, as did the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System and the Chairman of the CFTC and the Chairman of the Securities and Exchange Commission. Before turning to Senator Feinstein's amendment, it is useful to consider the two events now cited as support for proposals to expand the CFTC's jurisdiction over OTC derivatives.

### **The Enron Bankruptcy**

The well-publicized events leading to Enron's bankruptcy filing in December 2001 have raised serious concerns involving accounting practices, securities law disclosures and

corporate governance policies. ISDA shares the view that these issues deserve serious attention by policymakers and that, once the relevant facts are known, appropriate remedial actions should be taken. Some commentators have suggested, however, that Enron's OTC derivatives activities caused its demise and have concluded that this demonstrates the need for increased regulation of OTC derivatives by the CFTC.

ISDA disagrees. In a study entitled "Enron: Corporate Failure, Market Success", released in April 2002 (available on ISDA's web site), ISDA concluded the reasons for the failure of Enron did not, and does not, warrant new federal regulation of OTC derivatives. Had Enron complied with accounting and disclosure requirements it could not have built the "house of cards" that eventually led to its downfall.

The chain of events leading to Enron's bankruptcy simply does not warrant an expansion of the CFTC's regulatory authority with respect to OTC derivatives. With respect to the EnronOnline facility, ISDA understands that EnronOnline was operating prior to the adoption of the CFMA and did not rely on the CFMA for authority to operate. ISDA understands that EnronOnline was a bilateral dealer platform with Enron as the counterparty to every trade. In this respect, EnronOnline represented the migration of bilateral trading over the telephone to trading on the Internet. The sophisticated counterparties that entered into transactions with Enron through the Enron Online facility understood that they were bearing the credit risk with respect to Enron. That risk was handled by Enron's counterparties through methods such as the use of master agreements with close-out netting provisions and use of collateral arrangements.

These counterparties also benefited from provisions of the Bankruptcy Code adopted by Congress in 1990 that recognize the enforceability of close-out netting and from the legal certainty provisions of the CFMA that prevented Enron from walking away from unprofitable OTC derivatives transactions by asserting that they were illegal off-exchange "futures" contracts. Enron also allegedly used OTC derivatives in purported hedging transactions with partnerships it apparently controlled, but these related-party transactions clearly raise issues with respect to accounting and securities law disclosures.

Enron's off balance sheet activities actions appear to have been undertaken to mislead the market by creating the appearance of greater creditworthiness and financial stability than was in fact the case. The market in the end exercised the ultimate sanction over the firm. Even after Enron failed, the market for swaps and other derivatives worked as expected and experienced no apparent disruption. The OTC derivative market did not fail to function in the Enron episode.

Indeed, market participants have learned much about risk management in recent years. Considering the size of Enron, it is important to note that its failure did not have a systemic impact. While its counterparties, creditors, shareholders, and employees have incurred financial harm, Enron's failure did not lead to a failure of other firms.

In a special report published on February 19, 2002, The Financial Times set out an agenda for reform in response to events at Enron. In an article that is part of that special report entitled "A fresh look at rules for energy and finance", the Financial Times concludes that there is no need to regulate energy trading companies but there is a need for clearer reporting. This article notes that an "obvious response" to Enron's demise would be to revisit the exemption for Enron's energy trading from CFTC supervision. But the article cautions against pursuing this obvious response, reasoning as follows:

*"But before rushing to bring energy trading - and other unregulated professional and electronic markets - within the scope of the CFTC, it is worth considering what happened to these markets after Enron's collapse ... Nothing happened. The disappearance of a huge participant might have been expected to have a big impact on US energy markets. Yet the lights stayed on, the gas continued to flow. Because they were professional-to-professional markets, there was no damaging impact on consumers."*

As documented earlier in this statement, the CFMA was the result of thorough and open discussions by key policymakers and others over a period of years. It produced real gains in terms of legal certainty, an improved and flexible approach to regulation of the futures markets and enhanced the leadership position of the United States in financial

markets. The Enron collapse does not provide an acceptable policy basis for reversing that progress.

### **The California Energy Transactions**

The equally well-publicized transactions of Enron and others in or with respect to the California energy market have raised different public policy questions, namely, the design of the California electricity market, the lack of adequate reserves, demand response relative to growing electricity demand and possible manipulation of the wholesale market. ISDA views any credible allegations of “manipulation” in financial or other markets as a serious matter requiring attention and supports investigations by Congressional Committees, as well as federal agencies and departments, including the CFTC, the Federal Energy Regulatory Commission (FERC) and the Department of Justice.

ISDA shares the view expressed by key regulators during the recent floor debate on Senator Feinstein’s amendment that it would be premature to craft and adopt specific legislative changes before the various inquiries and investigations have been concluded. Congress will have to determine, on the basis of the facts as finally known, whether existing regulations were violated and whether an expansion of the authority of the FERC or the CFTC is necessary and appropriate to address the problems experienced in the California energy markets. For example, it is not obvious why the CFTC would be an appropriate regulator of the electricity market in California.

### **Senator Feinstein’s Amendment**

ISDA opposed Senator Feinstein’s amendment when it was initially offered in March and remains opposed to this effort. Key financial regulators including the Commodity Futures Trading Commission, the Securities and Exchange Commission, the Federal Reserve and the Treasury Department and over 50 entities in the financial services and energy industries also opposed the Feinstein amendment. It was ultimately defeated in a cloture motion on April 10, 2002.

ISDA believed then, and believes now, that this amendment should first be considered by the committees of the Senate and House that have jurisdiction with respect to the CEA. ISDA appreciates the willingness of this Committee to hold these hearings to fully discuss these important issues.

ISDA has also been of the view that the pending investigations should be completed before substantive amendments to the CEA are considered. To that end, ISDA opposes any future attempts to attach this amendment to pending Senate legislation prior to completion of these investigations.

In addition to these objections, ISDA also had substantial substantive concerns with respect to Senator Feinstein's amendment. As the amendment was presented to the Senate during the debate on S. 517, these concerns included the following:

1. Subsequent to its introduction, the amendment was modified so that it would no longer apply directly to financial derivatives such as interest rate swaps and securities based swaps, but it was not certain that these modifications were adequate to prevent the amendment from creating new legal uncertainty with respect to one or more types of financial derivatives.

2. The amendment is anticompetitive, as it did not apply simply to energy derivatives, but also to other exempt commodities such as metals. As a result, there would have been new and burdensome regulation of contracts (and parties to those contracts) in products that were not involved in the California energy transactions and for which the need for regulation was considered by Congress as unnecessary in 2000.

3. Even if the scope of the amendment was limited to energy (and any potential indirect effects on other OTC derivatives were eliminated), the amendment was still deficient. For example:

- a. Provisions of the amendment would have applied to any contracts in a covered commodity, whether or not that contract is a derivative or would otherwise be subject to regulation by the CFTC as a futures contract or commodity option.

b. The definition of “trading facility” was broader than current law and could conceivably have encompassed business contacts by telephone, email, and the like. The definition was not limited to exchange-style trading systems or traditional dealers and could have been interpreted to apply to the trading activities of a broad range of market participants.

c. The OTC derivatives business cannot practically be conducted under a regulatory framework for market intermediaries that is based on the CFTC’s existing regulation of futures commission merchants, particularly in terms of net capital and similar requirements. The CFTC’s historic mission has not involved the oversight of dealer activities, and the necessary supervisory expertise is not now within the CFTC’s core competencies.

d. In allocating jurisdiction between the CFTC and FERC, the amendment gave FERC jurisdiction over derivatives involving electricity and natural gas that are excluded from regulation under the CEA, a category of transactions that is not now within FERC’s jurisdiction.

### **Conclusion**

OTC derivatives are a major contributor to the flexibility and resiliency of our financial system that allows businesses, financial institutions, governmental entities and other end users to manage the financial and commodity market risks inherent in their economic activities. The CFMA established an appropriate regulatory structure for OTC derivatives by providing legal certainty consistent with the long-standing policies of Congress and the CFTC that OTC derivatives are not appropriately regulated under the CEA as futures contracts. This policy materially reduces systemic risk and creates a climate in which entities are able to manage risk in an efficient and effective manner.

Based on the facts now available, recent events do not justify rewriting the CFMA framework with respect to OTC derivatives. Indeed, it appears that the CFMA and the related provisions of the Bankruptcy Code may have enhanced the ability of market participants to deal with events such as the collapse of Enron.