

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 Exemption⁸ and the 1994 Hybrid Instrument Exemption⁹—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.

Recent Developments

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. Consistent Regulatory Framework

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

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 options¹⁰ 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
Chairman

Richard E. Grove
Executive Director and
Chief Executive Officer