June 8, 1998

Statement Submitted on Behalf of
The International Swaps and Derivatives Association, Inc.
To the Subcommittee on Risk Management and Specialty Crops
Committee on Agriculture
United States House of Representatives

This statement is submitted by the International Swaps and Derivatives Association, Inc. ("ISDA") to the House Subcommittee on Risk Management and Specialty Crops (the "Subcommittee") in connection with the Subcommittee's June 10, 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 Subcommittee'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 Subcommittee 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 the Administration proposal that "standstill" legislation be enacted this year 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. Such activities 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.

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

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"1/ 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").1/

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).

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 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.1/ 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]".1/ 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.1/ 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

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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.

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.1/ 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.

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".1/ 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]".1/

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.

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

9/ Id.

In response to the FTPA, the CFTC adopted an exemption for "swap agreements" in January 1993 (the "Swaps Exemption").1/ 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.1/ Exempted transactions still must meet certain criteria that are intended to distinguish them from exchange-traded agreements.1/ 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

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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.

CFTC, and (B) establishes that futures contracts on individual securities and certain narrow securities indices are illegal.

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".1/ 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

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

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.

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 Subcommittee 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".1/ 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.1/ However, the meaning of the term "board of trade" continues to give rise to potential legal concerns.1/

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 Subcommittee 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.

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).

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 Subcommittee 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,1/ 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.1/ 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

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

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

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 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 Report1/ , 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.

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

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 and the President's Working Group have had an opportunity to weigh these important issues.

ISDA welcomes the announcement by the Treasury Department, the Federal Reserve Board and the Securities and Exchange Commission that these agencies are proposing legislation to restrict the ability of the CFTC to propose changes in its existing regulations relating to swap transactions and hybrid instruments and to provide that swap transactions and hybrid instruments will not violate the provisions of Sections 2(a)(1)(B)(v) of the CEA. We look forward to the opportunity in the next Congress to work again with this Subcommittee, with the assistance of the study mandated by the proposed legislation, to modernize the CEA and once and for all clarify that the CEA is inapplicable to these types of privately-negotiated, individually-tailored risk management transactions. Until those changes to the CEA are made, the legislation proposed by Treasury, the Federal Reserve Board and the SEC is essential to ensure the continued availability of these important risk management tools to corporations, financial institutions and government entities.

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.