

PREPARED STATEMENT OF JOSEPH P. BAUMAN
ON BEHALF OF
THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.
BEFORE THE
SUBCOMMITTEE ON RISK MANAGEMENT AND SPECIALTY CROPS
COMMITTEE ON AGRICULTURE
UNITED STATES HOUSE OF REPRESENTATIVES

May 20, 1999

Chairman Ewing, and Members of the Subcommittee, I am Joseph P. Bauman, Managing Director of Bank of America. I am here today representing the International Swaps and Derivatives Association (which is widely known as ISDA). My firm is a member, and I am a former chairman, of ISDA. ISDA is an international organization and its more than 400 members include most of the world's primary dealers in principal-to-principal derivatives transactions and many of the businesses and governmental entities that use these transactions as an integral part of their risk management activities. In addition, our members are among the principal customers of the regulated futures exchanges.

I had the pleasure of appearing before the Subcommittee last year in connection with your review of the CFTC's concept release on derivatives instruments, and let me say at the outset, Mr. Chairman, that we appreciate both your continuing commitment to modernizing the Commodity Exchange Act and your leadership in 1998 in connection with the standstill legislation enacted to preserve the regulatory status quo--and market stability--so that Congress itself could consider and resolve the important public policy issues involved. As you know Mr. Chairman, ISDA has worked with the Subcommittee on these issues for more than a decade and, in this brief oral statement, I will summarize ISDA's views on several key issues that are of direct importance to our membership.

In broad policy terms, ISDA believes that the Commodity Exchange Act should be modernized to provide legal and regulatory certainty for financial contracts, to encourage financial innovation, and to facilitate competition in the United States and abroad. A modernized Commodity Exchange Act should foster efficient, liquid and low cost financial transactions not by limiting the alternatives available to firms desiring to manage their financial and operating risks, but by promoting alternative paths, each within an appropriate legal and regulatory structure. Regulatory burdens that increase the cost or reduce the availability of essential risk management tools to America's businesses and other end-users should be imposed only in those cases where less burdensome means, including market discipline, have not been effective.

There are a number of specific actions that Congress should take to achieve these broad policy goals. First, Congress should clarify once and for all that the Commodity Exchange Act does not apply to principal-to-principal derivatives transactions. In addition, regulatory relief should be provided to the organized futures exchanges to the maximum extent Congress concludes it is prudent to do so. ISDA and its members would welcome legislation that

modernizes exchange regulation, increases the autonomy of the exchanges, and enables them to move promptly to offer a broad array of risk management products.

Let me devote my remaining time, Mr. Chairman, to the critical issue of legal certainty for principal-to-principal derivatives transactions. For simplicity, I will in the balance of my testimony refer to these transactions collectively as “swaps” transactions. As explained more fully in our written statement, swaps transactions are powerful tools that enable America’s businesses to manage the risks that are inherent in their core activities, lower their cost of capital, manage credit exposures, and increase their competitiveness both here and abroad. Swaps transactions differ in many respects from exchange-traded futures contracts. One important difference is that the key economic terms of swaps transactions can be tailored to meet the specialized risk management needs of each end-user and it is this almost limitless flexibility that has led to the growth in the volume of these non-exchange risk management transactions.

Any uncertainty with respect to the enforceability of swaps transactions obviously presents a significant source of risk to the individual parties to those transactions. More importantly, any such uncertainty creates risks for the financial markets as a whole and precludes the full realization of the powerful benefits that swaps transactions provide. Our concerns about the impact of regulatory actions under the Commodity Exchange Act on the enforceability of swaps transactions are neither academic nor speculative. In 1998, unilateral actions by the CFTC suggested that the CFTC might treat certain swaps transactions as “futures”. This suggestion nearly shattered the settled expectations of the financial markets that swaps transactions were enforceable in accordance with their terms. The CFTC’s actions demonstrated conclusively that legal certainty and market stability can be undermined regardless of the CFTC’s intentions in pursuing a particular course of regulatory or enforcement action.

The experiences we shared in 1998 confirmed that, as we have known for years, the heart of the problem is in the structure of the Commodity Exchange Act itself. This means that the legal certainty issue can be clarified with the necessary finality only by Congress. There are several frameworks within which Congress could clarify that the Commodity Exchange Act does not apply to swaps transactions. These range from a complete restructuring of the Act to a more targeted and incremental approach to reform involving the clarification and expansion of exclusions. Each of these reform frameworks would readily accommodate broad regulatory relief for the organized futures exchanges.

Whatever reform framework the Congress chooses, Mr. Chairman, legal certainty should have four components. First, Congress should clarify that the Commodity Exchange Act does not apply to swaps transactions. This legal certainty should be extended to all forms of swaps transactions, including those based on securities prices, and not just to the transactions referred to in the so-called Treasury Amendment. Second, the Treasury Amendment should itself be clarified in certain respects to assure the continued enforceability of swaps transactions involving government securities and foreign currencies. Third, the broad scope of the CFTC’s 1998 proposed concept release underscores the need to assure that statutory provisions enacted by Congress to establish legal certainty cannot be used to impose non-legislative regulatory burdens on swaps transactions or participants in those transactions. Finally, as part of the legal certainty agenda, Congress needs to address questions related to emerging electronic technologies so that we will not shortly find ourselves enmeshed in another round of legal and regulatory uncertainty that will inevitably deter financial innovation and improvements in risk management. Each of these four points is developed more fully in our written statement.

Let me conclude, Mr. Chairman, by emphasizing once again that ISDA remains committed to working with the Subcommittee on a cooperative basis to assure that the key reform objectives of legal certainty for swaps transactions and regulatory relief for the organized exchanges are translated in legislative realities in this Congress.

Thank you, Mr. Chairman, and I would be pleased to respond to any questions you or other members of the Subcommittee may have.