

**TESTIMONY OF  
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INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.  
BEFORE THE  
COMMITTEE ON BANKING AND FINANCIAL SERVICES  
UNITED STATES HOUSE OF REPRESENTATIVES  
JULY 19, 2000**

Chairman Leach and Members of the Committee. I am pleased to appear before the Committee today to present the views of the International Swaps and Derivatives Association (ISDA) on H.R. 4541, the proposed “Commodity Futures Modernization Act of 2000”. ISDA is an international organization and its more than 475 members include the world’s leading dealers in off-exchange derivatives transactions (OTC derivatives) as well as many of the businesses, financial institutions, governmental entities and other end users that rely on OTC derivatives to manage their financial and commodity market risks with a degree of efficiency and effectiveness that would not otherwise be possible. ISDA has had the privilege of appearing before, and working with, this Committee for many years and we are pleased to be here today.

General Statement of ISDA Position

ISDA has consistently urged Congress to provide legal certainty for OTC derivatives transactions and this is a principal goal of H.R. 4541. The legal certainty provisions of H.R. 4541 generally conform to the framework for such legislation unanimously recommended by the President’s Working Group on Financial Markets and this framework now enjoys broad bipartisan support within the Congress. In addition, within ISDA’s extensive membership of dealers and end users, and elsewhere in the private sector, there is virtual unanimity that the framework of the legal certainty provisions of H.R. 4541 represents a pragmatic and workable solution to the public policy issues involved and that retention of this general framework is the only practical way to achieve the overriding goal of securing legal certainty legislation this year.

That is not to suggest that the legal certainty provisions of H.R. are “perfect”. Indeed, ISDA and others have submitted to this Committee, at your request Mr. Chairman, suggested changes to the legal certainty provisions of H.R. 4541. We also believe this Committee should make changes in the provisions related to clearing and add the so-called “cross-product netting” provisions to the bill. While these changes would strengthen the legislation, the critical point is that it is imperative that legal certainty legislation be enacted this year. These issues have been debated within the Congress for more than a decade, a broad consensus has at long last emerged and the time is at hand to enact legal certainty legislation.

The legal certainty provisions of H.R. 4541 will not simply reduce systemic risk. They will promote financial innovation by removing the barriers now imposed by the CEA on the use of new technologies for trading and clearing. U.S. financial institutions and U.S. technology companies are world leaders in their respective fields. From the broad perspective of our national interest, we should not compromise these leadership positions by maintaining regulatory structures that discourage financial institutions from using, and benefiting from, the most efficient and innovative electronic technology available.

We look forward to continuing to work with this Committee and others in Congress, as well as with the President’s Working Group, to improve the specific provisions of the legislation where there is general agreement to do so, but we must never lose sight of one overriding fact. Specifically, H.R. 4541, in its present form, is such a dramatic improvement over present law, and embodies such a broad consensus within both government and the private sector, that the failure, for whatever reason, to enact legal certainty legislation this year would send a disturbing signal to the broader financial markets.

As Senator Lugar observed in hearings before his Committee last month: “[T]he United States has lost its leadership role in the exchange-traded futures market to Europe and the over-the-counter market may not be far behind. Congress has a good opportunity to reverse this tide by enacting sound legislation this year”. At ISDA, we hope that Congress will fact in seize that opportunity and do so now.

### Importance of OTC Derivatives

OTC derivatives are powerful tools that enable American businesses and other end users in each of the 50 States to manage the interest rate, currency, commodity, credit and other related risks that are inherent in their core economic activities. In this way businesses and other users of OTC derivatives are able to lower their cost of capital, manage their credit exposures, and increase their competitiveness both here and abroad by focusing on their core area of expertise. The United States has been a leader in the development of OTC derivatives 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 probably the best evidence of their importance to, and acceptance by, end users. It is no coincidence that the U.S. economy and the volume of OTC derivatives transactions grew dramatically in the last decade. Indeed, as noted earlier, ISDA's members also include many of the businesses, financial institutions, governmental entities and other end users that rely on OTC derivatives to manage the financial and commodity risks inherent in their core economic activities with a degree of efficiency and cost effectiveness that would not otherwise be possible.

### Legal Certainty Provisions of H.R. 4541

#### Background of the Legal Certainty Provisions

As noted, a principal goal of H.R. 4541 is to provide legal certainty for OTC derivatives transactions. "Legal certainty" simply means that parties (both dealers and end users) must be certain that the provisions of the OTC derivatives contracts they enter into will be enforceable in accordance with their terms. Any uncertainty with respect to the enforceability of OTC derivatives contracts creates risks not only for the parties involved, but for the financial system as a whole.

In the United States, the CEA has been the principal source of legal uncertainty with respect to OTC derivatives. This is because the CEA generally prohibits off-exchange "futures" contracts. For more than a decade, Congress (including the leadership of this Committee), financial regulators and others worked actively to preserve and promote legal certainty that OTC derivatives contracts are not regulated as "futures"

contracts under the CEA. These actions created the climate within which OTC transactions emerged as a critical risk management tool.

Concerns that the CEA may create legal uncertainty are neither academic nor speculative. In 1998, unilateral actions by the CFTC suggested that the CFTC might erroneously treat some OTC derivatives as “futures” contracts and this suggestion nearly shattered the settled expectations of the broader financial markets in the United States that OTC derivatives transactions were enforceable in accordance with their terms. These concerns were sufficiently far reaching that Congress was required to impose a legislative moratorium on most CFTC actions with respect to OTC derivatives. That legislation also directed the President’s Working Group on Financial Markets to conduct a comprehensive study of the treatment of OTC derivatives transactions under the CEA.

The President’s Working Group submitted its report to Congress in November 1999. That report reflects 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 that Congress should enact legislation to provide legal certainty for OTC derivatives transactions. The report reflects a solid understanding of, and sensitivity to, the factors that enable the U.S. financial markets to so efficiently allocate capital and so effectively sustain economic growth.

The Working Group concluded that OTC derivatives based on financial commodities generally do not present public policy concerns (e.g., price discovery and consumer protection) of the type the CEA was intended to address and that legal certainty can therefore appropriately be provided by excluding these transactions from the CEA. The Working Group concluded that the enactment such legislation would reduce systemic risk and promote financial innovation. ISDA agrees with the Working Group that legislation is needed and needed now.

We welcome the regulatory initiatives being undertaken by the CFTC at the direction of its Congressional authorizing committees. The recently published proposal for a “New Regulatory Framework” reflects a welcome commitment by Chairman Rainer, his fellow Commissioners and the professional staff of the CFTC both to avoid measures that could create legal uncertainty and to adopt measures that will enhance legal

certainty within the constraints imposed by the existing structure of the CEA. There is, however, a broad consensus, shared by the CFTC as a member of the President's Working Group, that only Congress has the breadth of authority to provide a comprehensive solution to the legal certainty issue and that the time to do so is now.

#### Specific Provisions of H.R. 4541

Legal Certainty. Congress could of course provide legal certainty for OTC derivatives transactions in a variety of ways. For example, Congress could simply exclude all such transactions from the CEA irrespective of either the nature of the underlying commodity or the status of the counterparties. The Working Group rejected such an approach and instead proposed a framework for legislation which has been incorporated into H.R. 4541. This framework has attracted broad bipartisan support with the Congressional Committees that have taken action with respect to the legislation to date and, in ISDA's view, this framework represents a workable, and the only practical, way to achieve the critical goal of enacting legal certainty legislation this year.

Specifically, H.R. 4541 would retain and clarify the so-called Treasury Amendment to the CEA, which provides legal certainty for transactions in foreign currency, government securities and certain other enumerated transactions. ISDA supports retention of the Treasury Amendment and, at the request of Chairman Leach, has suggested certain changes to the provision. As recommended by the President's Working Group, H.R. 4541 strengthens the Treasury Amendment by substituting the term "organized exchange" for "board of trade" and explicitly providing for CFTC anti-fraud jurisdiction for certain "retail" futures transactions in foreign currency.

H.R. 4541 also adopts the recommendation of the President's Working Group that the CEA be amended to provide an exclusion from the CEA for OTC transactions based on financial commodities between "eligible contract participants". In addition, as also recommended by the President's Working Group, H.R. 4541 provides a new statutory exclusion from the CEA for hybrid instruments that are predominantly depository instruments or securities. ISDA supports these exclusions and, at the request of Chairman Leach, has submitted suggested improvements to them.

Consistent with the recommendations of ISDA and others, H.R. 4541 extends statutory legal certainty to a class of similar OTC transactions involving non-financial

commodities. For example, bilateral OTC transactions between “eligible contract participants” involving energy commodities will enjoy a statutory exemption from most provisions of the CEA. In addition, H.R. 4541 contains a provision, applicable to all OTC derivatives transactions between “eligible contract participants”, that will limit the ability of parties to such transactions to repudiate their obligations by reason of a failure to comply with the terms and conditions of a CEA exclusion or exemption or a CFTC regulation. This latter provision builds upon earlier legislation (H.R. 4203) introduced by Chairman Leach and Representatives LaFalce, Baker and Kanjorski. ISDA supports the goal of providing appropriate *statutory* legal certainty for a broad range of OTC derivatives transactions and has submitted, at the request of Chairman Leach, suggested improvements to these provisions that are consistent with the underlying framework adopted by the President’s Working Group. These suggestions include proposals to harmonize the “no repudiation” provisions of H.R. 4541 and H.R. 4203.

As noted, H.R. 4541 does not provide a statutory exclusion from the CEA for all OTC derivatives transactions. Certain classes of transactions, such as those on agricultural commodities, thus will be required to continue to rely on administrative exemptions issued by the CFTC for their legal certainty. While the tiered approach to legal certainty embodied in H.R. 4541 is consistent with the recommendations of the President’s Working Group, the adoption of such an approach makes it critical that a strong “no inference” clause be included in the legislation itself to ensure that the exemption and exclusion provisions contained therein will not at some future date be construed to reflect a determination by Congress that one or more categories or excluded or exempted transactions are or might be “futures” contracts. Likewise, it is important that the legislation be clarified to ensure that the decision of Congress not to provide a statutory exclusion or exemption for one or more categories of OTC derivatives transactions does not reflect, and should not be construed to reflect, a determination that any of these categories of transactions are or should be subject to the CEA. ISDA has, at the request of Chairman Leach, submitted recommendations to achieve this result.

Clearing. The President’s Working Group recognized that current law has discouraged the development of clearing systems. Consistent with the recommendations of the President’s Working Group, H.R. 4541 amends the CEA to ensure that the use of

clearing systems will not adversely affect the status of OTC derivatives transactions under the CEA, but it appears to some to provide an inadequate framework for regulation of clearinghouses. The President's Working Group has suggested revisions to the clearinghouse regulation provisions of H.R. 4541 and H.R. 4203 contains provisions on this subject. ISDA urges this Committee to address the question of clearinghouse regulation in a comprehensive and appropriate manner.

Netting. ISDA was an early leader in the advancement of close-out netting contracts and it agrees with the recommendation of the President's Working Group that Congress enact improvements in the netting regime for OTC derivatives and other financial transactions. Netting is important to the reduction of systemic risk. It generally serves to prevent the failure of one entity from causing additional market disruption by limiting losses to solvent counterparties and providing efficient resolutions for default situations in bankruptcy. In its testimony to the Committee earlier this year, ISDA reiterated its support for such legislation and noted that Chairman Leach and other Members of this Committee had developed legislation to achieve this objective. ISDA believes it would be appropriate for this Committee to add such provisions to H.R. 4541.

#### Conclusion

The enactment of the legal certainty provisions of H.R. 4541 will materially reduce systemic risk. Legal certainty for OTC derivatives transactions will enable businesses, financial institutions, government entities and other end users to manage the financial and commodity market risks inherent in their core economic activities in an efficient and effective manner.

Legal certainty for OTC derivatives transactions will foster financial innovation and the use of emerging technologies. The development of electronic trading systems will reduce systemic risk by increasing liquidity, efficiency and transparency of the financial markets. The ability of clearing systems to develop without regulatory impediments may reduce systemic risk by allowing financial institutions to reduce the possibility of widespread losses due to default. Finally, an improved close-out netting regime for OTC derivatives to allow orderly termination of financial contracts upon a counterparty's insolvency will preserve market liquidity and market stability and thus will limit serious market disruptions.

For these reasons, ISDA believes that it is critical that Congress enact consensus legislation this year to provide legal certainty for OTC derivatives transactions and we remain committed to continuing to work constructively with this Committee, other Committees, the Members of the President's Working Group and our colleagues in the private sector to achieve this result.