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Before the
U.S. House of Representatives
Committee on Agriculture
Subcommittee on General Farm Commodities and Risk Management
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Mr. Chairman and Members of the Committee:

Thank you very much for inviting ISDA and SIFMA to testify today regarding reauthorization of the Commodity Exchange Act. As you know this law is of great importance to users of privately negotiated derivatives, and in this time of increasingly competitive global markets your continued thoughtful leadership in this area is greatly appreciated.

About ISDA and SIFMA

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 810 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing legal opinions on the enforceability of netting and collateral arrangements (available only to ISDA members); securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Market Association, is based in Hong Kong.

The Success of the Commodity Futures Modernization Act

The derivatives industry is global in scale, with important centers of business existing in Europe and Asia as well as the United States. In that context, much of the business is managed and transacted locally, and has benefited from the U.S. legal and regulatory scheme.

The Commodity Exchange Act, as amended by the Commodity Futures Modernization Act of 2000, serves as a model for financial services legislation. At a time when commentators are increasingly urging the US to adopt a "principles-based" approach to financial market regulation it is important to note that this Committee achieved just that seven years ago. The Act provides a simplified approach to regulating on-exchange transactions in commodities while providing legal certainty for privately negotiated derivatives. By allowing market participants to chose the type and level of regulation they desire for their transactions the law affords the opportunity for maximum flexibility at minimum cost. This flexibility to choose among different types of products and markets has proven to be of tremendous benefit.

Since passage of the law in December of 2000 the derivatives business, both on exchange and off, has grown explosively. Since passage of the law U.S. dollar denominated on-exchange futures activity has grown 128%; US dollar denominated OTC activity, meanwhile, has increased 207%.[1] There is no question that this incredible growth has been spurred by the clarity of the law and the prudent oversight of the Commodity Futures Trading Commission.

The growth of the derivatives industry has meant the creation of a world of new risk management tools for American businesses and investors. It is now possible for a farmer to hedge against the risk of adverse weather affecting his crops, a pension fund manager to protect his retirees against the bankruptcy of a corporation whose debt it holds, a bank to protect against the default of loans it holds on its balance sheet, and an individual to protect against declining home values. All of these innovations have made the world financial system more resilient and allow businesses and individuals to focus on their core activities while minimizing their worries about events beyond their control.

Accompanying the growth in the derivatives business have come jobs and revenue for the United States. The financial services industry contains 5 percent of private sector jobs and produces 8.1% of GDP, making it the third largest sector of the US economy.[2] Nearly one in every 19 jobs in the country is in financial services.[3] Many of these jobs are at the cutting edge of innovation, creating a large number of patentable technologies.

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[1] Figures for US dollar denominated contracts do not provide a perfect substitute for US-based activity, but they do provide the most reliable available figures. OTC figures include interest rate, equity and foreign exchange contracts but do not include other commodities such as energy or precious metals.
[2] Interim Report of the Committee on Capital Market Regulation, page ix, November 30, 2006.
[3] Sustaining New York's and the US' Global Financial Services Leadership, page 10, January 2007.

The InterContinental Exchange, headquartered in Atlanta, provides an example. This American company employs over 500 people and has a market capitalization of over $9 billion; it is also on the forefront of creativity in both financial and high-tech innovation. It is no exaggeration to say that, were it not for the Commodity Futures Modernization Act of 2000, this highly successful US company would not be providing the jobs and revenue to the American economy that it is able to contribute thanks to that law.

Competitive Challenges to the U.S. Financial Services Industry

The tremendous economic growth engine that is the financial services industry has not gone unnoticed by the rest of the world. In Europe and Asia governments are rapidly working to reduce overly burdensome regulation in order to attract financial services business. As noted by New York Mayor Michael Bloomberg and Senator Charles Schumer in the letter accompanying their report on US financial services competitiveness, "in today's ultra-competitive global marketplace, more and more nations are challenging our position as the world's financial capital."[4] Indeed, in the area of derivatives America's lead has been more significantly challenged than elsewhere. Although the US remains home of the world's largest derivatives exchange (the Chicago Mercantile Exchange), it is followed closely by pan-European exchange Euronext.liffe[5] and the German-Swiss exchange Eurex. In the area of OTC derivatives, meanwhile, the US has lost its lead to the United Kingdom. The UK plays host to 43% of the world's OTC derivatives business, compared to 24% for the US. These figures are an increase of 7% and 6%, respectively, between April 2001 and April 2004.[6]

Part of the reason the UK has moved ahead of America in the OTC derivatives business has been attributed to regulatory advantages from operating out of London. One U.S. based business leader was quoted as saying "People feel less encumbered overseas by the threat of regulation and so are more likely to think outside of the box."[7] An example of this threat is the uncertainty imposed on market participants by efforts of the Federal Energy Regulatory Commission to regulate activities which appear to fall within the purview of the exclusive jurisdiction clause of the Commodity Exchange Act. A lack of clarity and legal certainty as to what activities are covered under which regulatory regime serves as a strong disincentive for doing business in the US.

Despite the loss in volume leadership in OTC derivatives the United States remains the source of many of the innovations occurring in that industry. The legal and regulatory certainty provided by the Commodity Futures Modernization Act and the CFTC have encouraged the creation of new products by American financial services firms. Nevertheless the loss of US leadership in the OTC business should be a worrying development for policymakers hoping to encourage growth in a vital US economic sector.

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[4] Ibid.

[5] Underscoring the global nature of these markets it is worth noting that Euronext.liffe is a subsidiary of NYSE Euronext, the holding company created by the combination of NYSE Group, Inc. and Euronext N.V., on April 4, 2007.

[6] Report on Derivatives, City Business Series, International Financial Services London, March 2006.

[7] Sustaining New York's and US' Global Financial Services Leadership, page 56.

No doubt this concern is why Congress recently directed that "Congress, the President, regulators, industry leaders, and other stakeholders should take the necessary steps to reclaim the preeminent position of the United States in the global financial services marketplace."[8]

Countervailing Concerns Regarding Reauthorization

Unfortunately, these concerns regarding a loss of US economic competitiveness come at the same time some end users in the energy market have complained that the prices they pay for certain commodities have been distorted. If true, these allegations would be worrisome not only for the end users, but for all market participants. In the long run no one benefits from markets which do not adequately reflect the forces of supply and demand, which is why the market users represented by ISDA and SIFMA strongly support continued vigorous oversight and, where wrongdoing is detected, prosecution, by the CFTC.

Fortunately for all market participants there does not appear to be strong evidence supporting the existence of widespread market abuse. In those cases where market abuse has been attempted the CFTC has been quick to act, and appropriately so. Nevertheless, despite the claims of some consumer and municipal groups, the case has not been made that fundamental changes in the law are necessary. It would be imprudent and damaging to America's companies and economy to change what has been a very successful law without conclusive evidence that changes are necessary to address a specifically identified problem.

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[8]Section 8007 of H.R. 2272, the America Competes Act (P.L. 110-69), provides:
It is the sense of the Senate that--

(1) Congress, the President, regulators, industry leaders, and other stakeholders should take the necessary steps to reclaim the preeminent position of the United States in the global financial services marketplace;

(2) the Federal and State financial regulatory agencies should, to the maximum extent possible--

(A) coordinate activities on significant policy matters, so as not to impose regulations that may have adverse unintended consequences on innovativeness with respect to financial products, instruments, and services, or that impose regulatory costs that are disproportionate to their benefits; and

(B) at the same time, ensure that the regulatory framework overseeing the United States capital markets continues to promote and protect the interests of investors in those markets; and

(3) given the complexity of the financial services marketplace, Congress should exercise vigorous oversight over Federal regulatory and statutory requirements affecting the financial services industry and consumers, with the goal of eliminating excessive regulation and problematic implementation of existing laws and regulations, while ensuring that necessary investor protections are not compromised.

Recommendations

The Commodity Exchange Act has provided a sound basis for the operation of both the exchange traded and privately negotiated derivatives businesses. In order to build upon that success ISDA and SIFMA recommend that Congress consider the following actions:

1) Provide the CFTC with the resources necessary to meet its staffing and IT procurement needs;
2) Undertake no changes to existing law in the absence of concrete evidence which conclusively demonstrates the existence of a market failure. The President's Working Group on Financial Markets should be included in any review of evidence purporting to show the existence of a market failure and the need to amend existing law.
3) In the event Congress and the President's Working Group are able to clearly identify a market failure, they should narrowly tailor any proposed changes to those areas which will impose the least cost while providing the greatest benefit to market users.
4) Reaffirm the exclusive jurisdiction of the Commodity Futures Trading Commission with respect to transactions on a registered exchange involving energy commodity derivatives.

Conclusion

The position of the United States as a center for financial services innovation is imperiled as perhaps never before. By adopting the Commodity Futures Modernization Act seven years ago Congress took great strides forward in promoting the growth of an important sector of the U.S. economy. To the extent changes in the law are proposed they should be viewed with an eye towards increasing U.S. competitiveness, and with a skeptical eye towards any proposals which would have the effect of increasing the attractiveness of foreign markets relative to the U.S. If concrete evidence of a market failure exists it should be identified and addressed in a narrow, targeted manner. However, the absence of any such evidence thus far strongly cautions against any changes. This approach would be consistent with Congressional intent when it enacted into law the "America Competes Act" last month.

This Committee has shown strong leadership in the past in promoting fair and competitive derivatives markets. This benefits market participants, end users, and ultimately all consumers, who enjoy the price protection that comes from more stable markets. Thank you for your continued leadership.