

Testimony of Greg Zerzan
International Swaps and Derivatives Association
Before the Commodity Futures Trading Commission
September 18, 2007

Chairman Lukken and Commissioners:

Thank you very much for inviting ISDA to testify today regarding trading on regulated exchanges and exempt commercial markets. This discussion comes at a time of continued dynamic growth for both the exchange traded and over-the-counter (OTC) businesses, and ISDA congratulates the Commission for its continued leadership in promoting fair, free and competitive derivatives markets.

About ISDA

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.

The Energy Markets

Recently, activity in the energy markets has caused some to question the current legislative and regulatory framework. Indeed, this summer the Senate Permanent Subcommittee on Investigations asserted that “excessive speculation distorts prices, increases volatility, and increases costs and risks for natural gas consumers, such as utilities, who ultimately pass on inflated costs to their customers.” In considering these charges it is important to consider the current state of the law as well as how the market functions in practice.

As the Commission is well aware, the derivatives markets (both OTC and exchange traded) play an important role in allowing end users to protect themselves from the risk of adverse movements in price. This protection is afforded in large part by speculators who

are willing to take on that risk in the hope of generating profit. Without them the markets would quickly collapse from a lack of liquidity, since conditions which might force a retreat from the market for a hedger do not necessarily provide the same motivation for a speculator. For as long as there have been markets speculators have been the source of suspicion and the object of opprobrium; but this is misplaced, as speculators are essential for an efficient market. The Commission's Office of the Chief Economist illustrated this relationship clearly when it released its study on "Market Growth, Trader Participation and Pricing in Energy Futures Markets" earlier this year.¹

The Current Regulatory Framework

The Commodity Exchange Act appropriately addresses the legitimate concerns which may arise when market participants are not exposed to price risk in the underlying commodity, or who may otherwise seek to profit from fluctuations in the market. The law gives the Commission the power to place limits on traders in order to prevent unwarranted or unreasonable changes in price; prohibits fraud and the manipulation of the price of commodities in interstate commerce; and requires reporting and recordkeeping in order to ensure the availability of information both for the Commission and the market. These protections have worked well, allowing the US to host some of the world's largest, most liquid commodity exchanges and reassuring market participants of the fairness of their transactions.

At the same time changes in the law in 2000 recognized that OTC derivatives, though economically similar to exchange traded futures, play a unique role in financial markets and the broader economy and do not lend themselves to futures-exchange type regulation. Therefore in the Commodity Futures Modernization Act of 2000 Congress codified exemptions and exclusions from the full suite of CFTC regulation for transactions among sophisticated market participants. Notable among these exemptions is section 2(h), which allows commercial entities to conduct transactions in non-financial and non-agricultural commodities such as oil, electricity and natural gas on electronic trading facilities which are subject to more limited CFTC oversight than are fully registered futures exchanges.

Thus the Commodity Exchange Act affords the opportunity to choose the type and level of regulation desired. This choice is available both to entities in the business of hosting transactions, such as exempt exchanges and contract markets, as well as to market users themselves, who may select what level of regulatory oversight they seek for their transactions. There is no question that from a purely quantitative perspective these changes have been an unqualified success. NYMEX average daily contract volume for crude oil increased by 90 percent from 2001 through 2006, and natural gas increased by just over 90 percent. OTC commodity derivatives excluding precious metals, meanwhile,

¹ "Market Growth, Trader Participation and Pricing in Energy Futures Markets," Drs. Michael S. Haigh, Jeffrey H. Harris, James A. Overdahl and Michel A. Robe, Office of the Chief Economist, Commodity Futures Trading Commission, February 7, 2007.

grew by over 850 percent from December 2001 to December 2005, according to the Bank for International Settlement. ²

Despite the tremendous growth these markets have enjoyed, some end users have complained that they are subject to manipulation, and that the underlying prices which end users pay for some commodities are distorted. However, strong and statistically sound evidence backing these assertions remains wanting. In those cases where some unscrupulous actor has attempted to manipulate the market, punishment has usually been swift and severe. As the Commission's enforcement record shows, while there is no shortage of people who will attempt to game the system for their own benefit the number of people who have successfully done so approaches nil. Ultimately the price of a physical commodity is determined by the inexorable forces of supply and demand; attempts to distort this are usually transparent, short-lived and to the detriment of the actor who tries.

Considerations When Proposing to Modify the Existing Regime

When considering whether or not to modify the current legislative and regulatory system on which the market depends for legal certainty, it is important to have a proper framework for determining whether such actions are warranted and in the best interests of the markets and users. As the global representative of the OTC business ISDA has the benefit of learning from the experiences of different regulators in different countries. Indeed, among other jurisdictions ISDA is heavily involved in the ongoing European Union review of the appropriate level of regulation for commodity derivatives under the Markets in Financial Instruments Directive ("MiFID"). The basis of that review affords an important perspective for our discussion today.

The MiFID review takes place within the context of the European Union's "Better Regulation" strategy. This strategy requires that when considering new government initiatives the European Commission must consult with industry participants and conduct a thorough impact assessment on the proposal. As stated by European Union Commissioner for Internal Markets Charlie McCreevy, this approach demands that regulators first ask 1) has there been a market failure; and 2) if so, is government intervention the best way to address it? It should be noted that under the "better regulation" strategy, Step 2 compels a thorough cost-benefit analysis.³

The European strategy is important to bear in mind for two disparate reasons: first, it articulates a methodology for approaching public policy issues which is clear,

² Testimony of Director Orice Williams, the Government Accountability Office before Subcommittee on General Farm Commodities and Risk Management, Committee on Agriculture, U.S. House of Representatives, July 12, 2007.

³ *'Regulators should only step in when needed. Only when absolutely necessary. Only when there is a market failure. Only when the benefits of action unambiguously outweigh the costs. We call this better regulation. This is a misnomer. It is smart regulation'* Commissioner Charlie McCreevy, Finance Dublin 8th Annual Conference, March 28, 2007, Dublin, Ireland.

understandable, and by most accounts highly effective. Indeed, the strategy reflects much of what is best in the CFTC's own procedures in seeking to initiate action. However, the guidelines presented under the "better regulation" strategy are so straightforward, and so clearly geared towards reducing unnecessary red tape, as to promote consensus among most of the industry participants who fall under the proposed rules.

The second reason the European example is important to consider is because, as the CFTC is well aware, we live in a time of highly competitive global markets—this competition applies not just to the markets themselves, but to the nations and economies which seek to attract the jobs and revenues which come from having commodity firms located in their respective jurisdictions. There is no question that the EU is very much focused on this aspect of competitiveness, and the better regulation strategy is in no small part designed to retain and attract businesses to Europe.

Application of the Better Regulation Test

It is thus a useful exercise to apply Commissioner McCreevy's formula to the question of whether the current US legislative and regulatory regime for commodity derivatives bears changing. Applying the first test, "has there been a market failure," as noted above there is little concrete evidence to support the conclusion that commodity prices reflect anything other than supply and demand. Attempts to demonstrate a correlation between derivative market activity and physical prices divorced from exogenous factors have been questioned as to their statistical methodology. Meanwhile, other reports (including those from the BIS, the IMF and the Commission itself)⁴ cast doubt on the notion that the increased presence of financial investors in the commodity markets has distorted prices or increased volatility. Notwithstanding the assertions of some industry end-users, there does not appear to be a strong supporting case for the existence of a market failure. At the very least, in considering whether to change the existing framework policy makers should conduct a thorough and comprehensive examination of this question.

Given that the case has not been made for the presence of a market failure, under the "better regulation" strategy the inquiry would be over. However, for purposes of this discussion it may be useful to nonetheless explore the second prong of the test, and ask "is government intervention necessary" to address any perceived imbalance? During the Senate PSI hearings legitimate questions were raised as to the relationship between contracts traded on a designated contract market and those traded on exempt commercial markets which rely at least in part on the settlement price of the exchange traded product. To the extent that policymakers are able to articulate a market failure extending from the relationship of such "linked contracts," it may be appropriate to promote the adoption of accountability limits by such an ECM. However, any proposed response to this alleged relationship should be narrowly tailored to address the perceived problem.

⁴ See "Financial Investors and Commodity Markets," Dietrich Domanski and Alexandra Heath, Bank for International Settlements Quarterly Review, March 2007.

Conclusion and Recommendations

The competitiveness of the United States as the leading source and location for the financial services industry is threatened now as perhaps never before. This is no doubt 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.”⁵ When considering whether statutory or regulatory changes are necessary, the Commission should consider whether the costs of any proposed changes outweigh the perceived benefits. The derivatives industry is without question one of the outstanding success stories of US financial innovation, in no small part because of the prudent leadership of the Commission. That leadership is needed now as much as ever. ISDA recommends that the CFTC undertake the following actions with respect to exchange traded and OTC derivatives:

- 1) The Commission should continue to seek to reduce unnecessary burdens on both exchange traded and OTC energy derivatives, in order to ensure market participants are allowed to access different products and markets with maximum efficiency and minimum costs;
- 2) The Commission should undertake a thorough study of all available evidence, including academic research, relating to the relationships among the OTC, exchange traded and physical commodity markets. This inquiry should be directed towards determining whether there exists a “market failure” in the energy

⁵Section 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.

- markets. If necessary or beneficial, the Commission should propose that the President's Working Group on Financial Markets participate in this project.
- 3) To the extent the Commission finds evidence of the existence of a market failure, the Commission should undertake a thorough cost benefit analysis in order to outline the most narrowly tailored, least burdensome approach to addressing any clearly identified market failure.
 - 4) The Commission should continue to forcefully reject efforts to increase regulation of the commodity markets in the absence of clear and convincing evidence that any such change to the status quo is warranted from both an evidentiary and cost-benefit analysis.

Thank you very much for allowing ISDA to testify today.