HEARING TO REVIEW DERIVATIVES LEGISLATION

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HOUSE OF REPRESENTATIVES

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HEARING TO REVIEW DERIVATIVES LEGISLATION

TUESDAY, FEBRUARY 3, 2009

HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Committee met, pursuant to call, at 1:05 p.m., in Room 1300, Longworth House Office Building, Hon. Collin C. Peterson [Chairman of the Committee] presiding.

Members present: Representatives Peterson, Boswell, Scott, Marshall, Walz, Kagen, Schrader, Halvorson, Dahlkemper, Massa, Bright, Markey, Schauer, Kissell, Boccieri, Pomeroy, Minnick, Lucas, Graves, Neugebauer, Conaway, Fortenberry, Latta, Roe, and Thompson.

Staff present: Adam Durand, John Konya, Scott Kuschmider, Clark Ogilvie, John Riley, April Slayton, Debbie Smith, Kristin Sosanie, Tamara Hinton, Kevin Kramp, Bill O'Conner, Nicole Scott, and Jamie Mitchell.

OPENING STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

The CHAIRMAN. The Committee will come to order.

We have Members coming in. We don't have votes until 6:30, so I appreciate the Members making an effort to come back. I think we will have more Members joining us.

Good afternoon to everybody, and welcome to today's hearing on derivatives legislation.

For those on the Committee who were here in the 110th Congress, today's hearing will cover many of the issues and topics considered during the nine hearings held last year on this subject. The effort to strengthen oversight and improve transparency in derivatives markets, whether regulated or unregulated, whether they are physically based commodities or financial commodities has been a top priority of this Committee.

For those of you who are new to the Committee, welcome to the fire. Members and staff have been working hard on this issue since the last Congress adjourned, and it is my intent to move expeditiously this month; because every day we delay is another day where markets operate without the oversight or transparency they desperately need.

Last year, we began our journey with extensive public hearings on the issue of speculation, lack of convergence, lack of effective oversight, and increased transparency of derivative markets. The result of those hearings was a strong bipartisan bill that had more than ⅔ majority when it passed the House last September.

We will continue this effort in the 111th Congress, but this time with new provisions resulting from the hearings we held late last year on the role of credit derivatives in the economy after the collapse of large financial institutions that were heavily engaged in the over-the-counter derivatives transactions and market.

The language that I circulated last week, and that this Committee will be discussing, contains provisions similar to last year's bipartisan bill. It will strengthen confidence and trader position limits on all futures markets as a way to prevent potential price distortions caused by extensive speculative trading. It would close the so-called London loophole by requiring foreign boards of trade to share trading data and adopt position limits on contracts that trade U.S. commodities linked to U.S.-regulated exchanges. It would direct the CFTC to get a clearer picture of the over-the-counter markets, and it calls for a new full-time CFTC staff to improve enforcement, prevent manipulation, and prosecute fraud.

This proposal would bring a sense of order to the over-the-counter market by requiring transparent central clearing for all OTC derivatives. The legislation contemplates multiple entities, whether regulated by the CFTC, the SEC, or the Federal Reserve, offering clearing services for the market. In that sense, it is modeled after the current law. However, the bill requires these clearing entities to follow the same set of core principles in their operations as a means of avoiding regulatory arbitrage.

The failures of AIG, Lehman, Bear Stearns, and other institutions have shown us that it is time for some transparency in the market for credit derivatives. The way for us to identify and reduce the risk out there is to facilitate clearing it.

The draft bill provides the CFTC with authority to exempt some derivatives from clearing in recognition of the fact that not every OTC trade is suitable for clearing. However, those seeking to remain in the derivatives business without clearing will have to report their actions and demonstrate their financial soundness.

In the debate over credit derivatives, there has been much discussion about choosing the proper regulator, whether it is the CFTC, the SEC, or the Fed. I have made it clear that I believe the CFTC is the agency that has the knowledge and the expertise in these markets.

I am flat-out opposed to the Fed having a role in clearing or overseeing these products. If I could have my way, the Fed would not be involved. However, that is probably not a political reality of today, and the draft legislation reflects that.

The Federal Reserve is an independent banking system, not a police officer of derivatives transactions. I share the concerns of those who think the Fed controls too much already. They are an unelected body that sets monetary policy, oversees its state member banks, oversees holding companies, and now they are printing money for the bailout.

I am not surprised that the large banks are clamoring for the Fed to regulate derivative activity, given their cozy relationship with Fed members. Plus, they probably think it is a good idea to have a regulator with resources to bail them out if things go wrong.

I am also strongly opposed to allowing the SEC to have primary authority over these contracts. The SEC uses a rules-based system that is behind the curve of today's modern, complex financial products and in my opinion is just not workable. They are not just trying to solve yesterday's problems or last week's problems; they are still trying to solve the last decade's problems. As a result, they have done a poor job.

How much confidence can we have in an agency that repeatedly ignored calls even from within its own agency to examine the investment advisory business of Bernard Madoff, which turned out to be the biggest Ponzi scheme in history? They gave them a road map as to what was going on; and they missed it. They even missed the red flags in their oversight of Bear Stearns, as was detailed in a report by the SEC Inspector General.

Other people are trying to use the problems of credit default swaps as an argument to create a super financial regulator. However, in my opinion, taking something that is working, like the CFTC oversight of the futures market, and moving it to another place where things are not working is, frankly, crazy. To name a financial czar or a single super-regulator over the whole thing is an even worse idea and has the potential to create financial markets' version of the Department of Homeland Security, which a lot of us don't want to see happen. So I don't want to even imagine the problems that we would create if we would go down that avenue.

So as this Committee moves forward on this matter, we will continue to work on a bipartisan basis on this bill. We will do our work out in the open, and we will listen to any and all who want to comment. That is what we did with the farm bill, with the reauthorization of the Commodity Exchange Act and with our examination of speculation. The result of that approach was passage of strong bipartisan legislation last Congress that had the support of the Ranking Member at the time, Mr. Goodlatte, and it received ⅔ of the vote in the House.

This is must-pass legislation, in my view, which is why we need to move quickly; and that is why I have circulated this language, and why we are holding these hearings today and over the next couple of weeks. So I welcome all of today's witnesses and the Members to the hearing. I look forward to their testimony.

[The prepared statement of Mr. Peterson follows:]

PREPARED STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Good afternoon and welcome to today's hearing on derivatives legislation.

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Plus, they probably think it is a good idea to have a regulator with the resources to bail them out when things go south.

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Other people are trying to use the problems with credit default swaps as an argument for creating a super financial regulator. However, in my opinion, taking something that is working, like CFTC oversight of the futures markets, and moving it to another place where things are not working is just crazy. To name a financial czar or single super regulator over the whole thing is an even worse idea that has the potential to create a financial markets version of the Department of Homeland Security. I don't want to even imagine the kind of mess that would create.

As this Committee moves forward on this matter, we will continue to work on a bipartisan basis on this bill, and we will do our work out in the open and listen to any and all who want to comment. That is what we did with the farm bill, with reauthorization of the Commodity Exchange Act, and with our examination of speculation.

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This is must-pass legislation, in my view, which is why we need to move quickly. That is why I have circulated this language and why we will be holding hearings over the next 2 weeks.

I welcome today's witnesses and I look forward to their testimony. At this time I would like to yield to Ranking Member Lucas for an opening statement.

The CHAIRMAN. At this time, I would yield to Ranking Member Lucas for an opening statement.

OPENING STATEMENT OF HON. FRANK D. LUCAS, A REPRESENTATIVE IN CONGRESS FROM OKLAHOMA

Mr. LUCAS. Thank you, Chairman Peterson, for calling today's hearing. We appreciate the opportunity to examine your draft legislation that addresses concerns with the derivatives industry and its impact on the U.S. economy.

During the past several months, the Committee has spent a great deal of time monitoring the issue of trading activity in the futures market, as well as exploring the role credit default swaps have played in our current financial crisis. The draft legislation we are considering would impact a wide array of financial instruments, and what the ultimate effect will be in the marketplace is unknown.

My main concern is how the legislation will impact risk management for agricultural producers. How far will this legislation go beyond credit default swaps and derivatives in general? I support greater transparency and accountability in respect to the over-the-counter transactions. However, I also believe any legislation to regulate financial markets has to strike a delicate balance between protecting the economic workings of this country and creating opportunities for economic growth, business expansion, risk management for our agricultural producers. To that end, I believe this Committee must work to ensure that the Commodity Futures Trading Commission, the CFTC, plays a leading role in appropriately regulating the derivative and commodity markets once the Committee decides what level of additional regulations are needed.

We should also work to ensure that the CFTC has the tools it needs, human resources, technical resources, economic resources to effectively carry out its statutory mandate. It must be noted that the CFTC has a proven track record in clearing futures contracts, and to date has not lost a single dollar of a single customer's money due to failure of a clearinghouse.

Finally, I would like to thank the participants of our two panels today. We appreciate your time and your commitment to the public policy process, and we look forward to your testimony and answers to our questions.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman and his staff for working with us through this process. We have been working on a bipartisan basis, and we will continue to do that.

The chair would request that other Members submit their opening statements for the record so that witnesses may begin their testimony and we ensure that we will have ample time for questions.

[The prepared statement of Mr. Graves follows:]

PREPARED STATEMENT OF HON. SAM GRAVES, A REPRESENTATIVE IN CONGRESS FROM MISSOURI

Thank you, Chairman Peterson and Ranking Member Lucas for holding this hearing to review the Chairman's draft bill on derivatives legislation.

Investor Warren Buffet has described the multi-trillion dollar market in financial derivatives as the equivalent of a financial pearl harbor. The unregulated and often shadowy market in financial derivatives trading has contributed greatly to the uncertainty and volatility that is paralyzing financial markets and hindering our economic recovery.

Sunshine is often the best policy. Last Congress I sponsored legislation to bring greater regulatory oversight and transparency to the over-the-counter trade in natural gas contracts. As many Members of this Committee know, natural gas is an important component of many agriculture products, including fertilizer.

While my bill was focused on combating market manipulation, I believe its transparency components are applicable here, to financial derivatives.

Like anything, the devil is in the details and I look forward to learning more about the Chairman's proposal and hearing the opinions of today's panel. Again I would like to thank the Committee for holding this hearing.

Thank you.

The CHAIRMAN. So, with that, without objection we would like to welcome our first panel of witnesses to the table.

First, we have Mr. Tom Buis, the President of the National Farmers Union. Welcome. Mr. John Damgard, the President of the Futures Industry Association; Mr. Michael Greenberger, Law School Professor at the University of Maryland School of Law; Mr. Michael Gooch, the Chairman and Chief Executive Officer of GFI Group, Incorporated, of New York; Mr. Sean Cota, President of Cota & Cota, Incorporated, on behalf of the Petroleum Marketers Association of America and the New England Fuel Institute of Bellow Falls, Vermont; and Mr. Terrence Duffy, the Executive Chairman of the Chicago Mercantile Exchange Group, Incorporated, of Chicago, Illinois.

So, gentlemen, welcome to the Committee, welcome to the panel. We look forward your testimony.

Mr. Buis, you can begin, if you are ready.

STATEMENT OF TOM BUIS, PRESIDENT, NATIONAL FARMERS UNION, WASHINGTON, D.C.

Mr. BUIS. Thank you, Chairman Peterson, Ranking Member Lucas, and Members of the Committee. It is indeed an honor to be able to testify on this important issue before the Committee.

We got involved in this last winter and spring, when we started receiving numerous phone calls from farmers. As wheat prices hit record levels, corn prices were also in the record category. Farmers were calling and saying they couldn't market their grain the way they would normally market it, which is, by and large, being able to price their grain after harvest for delivery. When they were precluded, they were told that the reason was many of the local elevators and co-ops were running up against their credit limits because the prices of the commodities were going up to the limit day after day and having to meet those margin calls; and their only alternative was to quit offering futures contracts after harvest.

So, we contacted the CFTC and urged them to take a look at it, not long after they held a hearing. There were a number of people there, but they started out the hearing, and basically they went through all of their data and concluded before the hearing was even over that nothing out of the ordinary was happening.

Well, Mr. Chairman, something out of the ordinary was happening. Farmers, who were probably the original derivative, were being precluded from the marketplace at a time when they could have really capitalized on the higher market prices. So we were a little frustrated with the reaction.

As the year went on, we began to find out more and more that really what was causing higher food prices, really what was causing higher input costs was the excessive speculation that was going on in the commodity markets. Whether you look at oil, whether you look at grains, you look at any of the inputs, fertilizer, they were all based on either energy and/or future feed use or future use for other processing. As a result, farmers and ranchers didn't get the high prices and had to wait for prices to come down at harvest in order to sell their wheat and other commodities.

We also witnessed something that I don't think anyone can explain, and that is the cotton market virtually doubled overnight. Our impression is that we have a lot of cotton in storage. It is difficult to move. As a result, it was definitely a speculative market that lasted a very short time. I have yet to meet a cotton farmer that got those pries up in the 90¢ range for their cotton.

So we were impacted tremendously. I think it caused higher food prices, which impacted consumers. It caused a divisive attitude among agriculture producers, because livestock producers were being told that corn prices and feed prices were going to go even higher. So they had to lock in their prices.

I just got back from Central Valley of California, Mr. Chairman, and many of those producers that locked in feed prices because they believed all the speculative reports that prices were going to continue to rise, and they did the prudent thing in locking in their future feed uses, and now they are all in as bad a financial shape as I have ever seen in the dairy industry. It is the same for other livestock producers and livestock processors.

Ethanol companies did the same thing. They were all sort of wrapped up in this speculative environment.

So I really commend you for your efforts, both last year and this year, to move forward. It is badly needed. Your legislation is right on target establishing speculative limits for all commodities, the increased transparency, providing the resources for CFTC, and including even carbon credits to be traded on the marketplace and a regulated marketplace. Actually being able to give the regulators a chance to know how much money is in there, who it is by, whether it is commercial, whether it is speculative, or whether it is under an exemption or over-the-counter or foreign exchanges has to be done. I think it is the most important thing for the rural economy, which, as you know, has certainly flipped in the last few months.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Buis follows:]

PREPARED STATEMENT OF TOM BUIS, PRESIDENT, NATIONAL FARMERS UNION, WASHINGTON, D.C.

Good afternoon, Mr. Chairman and Members of the Committee. I appreciate the opportunity to testify on behalf of the farm, ranch and rural members of National Farmers Union (NFU). NFU was founded in 1902 in Point, Texas, to help the family farmer address profitability issues and monopolistic practices while America was courting the Industrial Revolution. Today, with family farm, ranch and rural family members, NFU continues its original mission to protect and enhance the economic well-being and quality of life for family farmers and ranchers and their rural communities.

Last spring, NFU called upon the Commodity Futures Trading Commission (CFTC) to conduct a thorough and comprehensive investigation regarding the activity and volatility in the commodities markets. In particular, the role of speculative commodity futures trading, both on and off-exchange, in increasing that volatility, with much of that trading hidden from view of the CFTC in the derivatives and other off-exchange markets.

Farmers and ranchers are generally relieved to end the 2008 agriculture market roller coaster, but they are extremely anxious as they approach the 2009 production year. During 2008 we witnessed periods of record or near record nominal prices for many commodities traded on U.S. exchanges. As the year ended, we have also witnessed a historic collapse in market prices for major grains and dairy products.

NFU was frustrated by remarks from some CFTC officials who suggested that the market volatility was simply a response to market fundamentals. This assessment did not adequately explain the price shock in the cotton market or lack of convergence between cash and futures markets during the contract settlement period. This assessment also failed to explain why many farmers were precluded from utilizing traditional market risk management tools, such as forward cash contracts, because of excessive margin risk to those who typically would offer such products to their customers.

As speculators created a market bubble and attitude that higher prices were set to stay, crop, livestock and dairy producers locked in higher inputs and feed costs. The false signals were not reserved for agricultural producers, but extended beyond production agriculture to the ethanol and biodiesel industries and input suppliers, all locking in higher feedstocks and supplies. The 2008 economic collapse and bursting of bubble have jeopardized the economic livelihoods of all these players, which will ripple throughout our rural communities. This impact will not be short-lived, as it could take up to a year or longer before the negative impact is resolved.

In these times of despair, commodities and industries become pitted against each other creating a divisive environment in which to establish helpful policy. As you can imagine, it was very frustrating for farmers who were paying record amounts for inputs, but could not implement effective marketing plans or strategies to take advantage of the higher prices for their crops. While this activity was occurring in 2008, the media, with help from food processors, held fast to the position that farmers and ranchers were getting rich from record high commodity prices and cited these prices as the sole cause of increasing retail food prices. Nothing could have been further from the truth. The reality of what happened has come to light as commodity prices have plummeted, yet retail food costs remain high.

The effort being made by this Committee to ensure that we do not experience a repeat of 2008, is to be commended. It became obvious, in a number of areas, that modernized regulations were warranted to ensure the mistakes of the past are not repeated. The broad, bipartisan support for increased oversight and transparency with the House-passed Commodity Markets Transparency and Accountability Act of 2008 provided a good starting point. The Derivatives Markets Transparency and Accountability Act (DMTAA) of 2009 would be of even greater benefit to agricultural producers and the entire economy.

In a letter to the CFTC last year, NFU cited the single biggest concern among producers as a lack of market transparency. This is still the case. Provisions within the DMTAA, seek to inject necessary transparency through the detailed reporting and disaggregation of market data and the over-the-counter (OTC) transparency and record-keeping authorities as outlined in the legislation. Without these provisions, the public will continue to be in the dark regarding who is involved in commodity markets and to what capacity. These new authorities are needed to ensure regulators are able to keep pace with the use of new financial and market instruments that result in market manipulation, fraud or excessive speculative market volatility.

NFU has called for an investigation to determine the role and impact that OTC trading and swaps have on markets. Without full access to data and other information concerning these types of trading activities, it is impossible to determine whether manipulation, fraud or excessive speculation is occurring. DMTAA requires all prospective OTC transactions to be settled and cleared through a CFTC regulated clearinghouse or other appropriate venue. The addition of principles for the designated clearing organizations, including (1) daily publication of pricing information; (2) fitness standards; and (3) disclosure of operational information, will protect the integrity of the new OTC requirements by assuring the clearinghouses remain transparent.

The legislation also requires the CFTC to study and report on the effects of potential position limits within OTC trading. Again, this information will enhance the public's confidence that markets are not being manipulated, fraudulently exploited or overwhelmed by speculation and if so, corrective action can be launched.

When the CFTC proposed increasing speculative position limits in 2007, NFU filed public comments in opposition to such action. Speculators have an important role to play in the commodity markets in terms of providing market liquidity. However, when left unregulated and allowed to become excessive, the positive attributes that speculators bring to the markets undermines the legitimate price discovery and risk management functions these markets were designed to provide to commercial market participants. DMTAA establishes new standards and limits for all commodities.

Moreover, we are pleased to see the establishment of a Position Limit Agricultural Advisory Group. By involving producers and traditional users of the market in making recommendations concerning position limits, the new limits will be legitimized and fair. With the rapid growth of market speculation, we are in unchartered waters today and we believe this third-party review function can significantly help in ensuring market integrity in the future.

NFU believes the CFTC needs to take a broader look at the concept of manipulation and it implications for price discovery. Unfortunately, the CFTC's test to determine manipulation requires that an individual or group of traders acquire a market position that enables them to ***consciously*** distort prices in noncompliance with market fundamentals. What the CFTC is failing to recognize is that the deluge of money from Wall Street, hedge funds and other large traders in and of itself is driving prices in ways that may not reflect the fundamentals of the underlying markets.

In 2006, NFU became an approved aggregator for trading carbon credits on the Chicago Climate Exchange (CCX). Currently, we are the largest aggregator of agricultural soil carbon offsets to CCX. The CCX is the world's first greenhouse gas emissions registry, reduction and trading system, trading more than 86 million tons of carbon offsets to date. As carbon trading continues to advance rapidly, NFU appreciates the provision within the legislation that will protect the integrity of carbon credit trading by requiring those contracts to be traded on a designated contract market. Furthermore, the cross pollination between the CFTC and the U.S. Department of Agriculture to develop procedures and protocols for market-based greenhouse gas programs will help ensure these markets will perform a legitimate function for participants and the public in general.

This legislation will begin to answer many of the questions from 2008. We are currently enduring the train wreck caused in large part by the dysfunction of the futures market—in 2008.

NFU strongly endorses this bill and looks forward to its swift approval; I am hopeful Congress will continue its bipartisan efforts to establish greater oversight of the commodity and energy futures markets. I thank the Committee for the opportunity to be here today and look forward to any questions you may have.

The CHAIRMAN. Thank you, Mr. Buis, for your statement.

Mr. Damgard, welcome to the Committee.

STATEMENT OF JOHN M. DAMGARD, PRESIDENT, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Mr. DAMGARD. Thank you very much, Mr. Chairman.

Chairman Peterson, Ranking Member Lucas, and Members of the Committee, I am John Damgard, President of the Futures Industry Association; and, as the principal spokesman for the U.S. futures industry, FIA is pleased to be able to testify on the Derivatives Markets Transparency and Accountability Act of 2009. But before addressing the far-reaching legislation, I want to step back and try to put it in some context.

In recent months, our economy has faced unprecedented financial turbulence, leading to bankruptcies and bailouts. During that time, U.S. futures markets have performed flawlessly. Fair and reliable prices have been discovered transparently, hedgers have managed price risks in liquid markets, all trades have been cleared, customers have been paid. Not a blip. This record of excellence is the best evidence possible that the regulatory system established by this Committee works superbly well. It is also the best evidence that the Commodity Futures Trading Commission has done its job, and done it well. The Committee should take pride in both the regulatory structures you put in place and the agency that you created years ago. Other agencies should learn from the CFTC.

But, in any event, a simple merger is not the answer; and, in that regard, I agree with both the Chairman and the Ranking Member.

The legislation before you would build on existing regulatory structure to enhance the CFTC's current powers. We support additional special call and other transparency provisions to allow the CFTC to strengthen its market surveillance capabilities, we support additional resources for the CFTC, we support coordinated oversight of linked competitive markets, and we support looking at further ways to adapt CFTC regulation to the ever-increasing pace of market innovation. But, despite our support in those areas, FIA cannot support the bill as a whole.

Our major objections rest in three areas: number one, the hedge exemption; number two, mandatory clearing of all OTC instruments; and number three, the ban on naked credit default swaps. The bill's narrow hedging definition erases decades of progress to expand the use of regulated futures markets by businesses that use futures in an economically appropriate way to manage their price risks. Those companies are not anticipating higher or lower prices. They are managing a risk of higher or lower prices that they already face. In fact, if the companies do not manage that risk, they would be speculating.

But if this bill becomes law and constraining positions are imposed, then automakers could not hedge gasoline prices, agribusiness could not hedge currency prices, airlines could not hedge interest rates, and utilities could not hedge weather risk. This would be bad economic policy at a time when we need stability, not uncertainty. Mandating clearing of all OTC derivatives would lead to market uncertainty or worse.

You might think that I would support clearing everything, because my regular members are the clearing members whose businesses would increase if everything were cleared. But we don't support mandatory clearing for all OTC derivatives. Some derivatives are too customized and their pricing too opaque to be cleared safely and efficiently. Making it illegal not to clear an OTC derivative would, therefore, be a recipe for economic instability and litigation.

FIA believes clearing should be encouraged through capital treatment or other regulatory measures. FIA also believes that if the Committee insists on a clearing mandate, it should be coupled with a flexible CFTC power to exempt classes of instruments from that mandate.

Unfortunately, the draft bill's exemptive powers are so limited we fear the CFTC would only be able to exempt a sliver of the current OTC market, leaving the rest facing intolerable legal uncertainty or the ability to do this business somewhere outside the United States.

Last, we oppose the ban on naked credit default swaps. The ban would remove important liquidity from our credit markets at just the wrong time for many struggling businesses. FIA would prefer to see Congress encourage clearing of CDS instruments and provide more effective, systemic risk protections through oversight of the institutions that enter into these transactions.

Mr. Chairman, FIA thanks you very much for the opportunity to testify this afternoon, and I look forward to answering any questions.

[The prepared statement of Mr. Damgard follows:]

PREPARED STATEMENT OF JOHN M. DAMGARD, PRESIDENT, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Chairman Peterson, Ranking Member Lucas and Members of the House Agriculture Committee, I am John Damgard, President of the Futures Industry Association. The FIA is pleased to be able to testify on the discussion draft of the Derivatives Markets Transparency and Accountability Act of 2009.

Introduction

FIA understands well the interest of Chairman Peterson and others in crafting this draft bill. Financial derivatives are now an integral part of our national economy and have been used by many businesses to reduce the multi-faceted price risks they face. Some of these derivatives and related market structures have evolved since Congress considered major changes to the Commodity Exchange Act in 2000. Some have even become more prominent since Congress adopted important changes to the Act as part of the 2008 Farm Bill. Given this Committee's experience and history with derivatives regulation, FIA welcomes discussion with the Committee on whether we need to bolster existing regulatory systems at this time.

The draft bill is far-reaching. It would make substantial revisions to the Commodity Exchange Act that would affect trading on exchange markets as well as over-the-counter transactions. While FIA is the trade association for the futures industry,[1] and its traditional focus has been on exchange markets, we try to take a holistic view of futures and other derivatives markets in order to advise the Committee on what our members believe would be the best public policy for our country and our industry.

Draft Bill

FIA has analyzed the draft bill through the prism of the congressional findings that form the foundation of the Commodity Exchange Act. Congress has found that the Act serves the public interest by promoting the use of liquid and fair trading markets to assume and manage price risks in all facets of our economy, while discovering prices that may be disseminated widely. CFTC regulation fosters those interests through four core objectives:

- preventing price manipulation,
- avoiding systemic risk and counterparty defaults through clearing,
- protecting customers, and
- encouraging competition and innovation.

FIA supports these Congressional findings and objectives. They are valid today as they were when first enacted. In FIA's view, some of the draft bill's provisions are consistent with these findings and objectives. We support those provisions which would strengthen CFTC market surveillance capabilities and deter price manipulation, by adapting the current regulatory systems to ever evolving market innovations. We also support the pro-competition decisions embodied or implicit in the bill's provisions.

But many of the draft bill's provisions would *disserve* the very public interests and economic policies Congress designed the CEA to serve by draining market liquidity, making hedging more costly, curbing innovation and discouraging trading in the U.S. We can not support those sections of the bill. Attached to this testimony FIA

[1] FIA is a principal spokesman for the commodity futures and options industry. Our regular membership is comprised of 30 of the largest futures commission merchants in the United States. Among our associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members serve as brokers for more than ninety percent of all customer transactions executed on United States contract markets.

has included a section-by-section review of the draft bill which describes our positions on its specific sections.

FIA's Principal Objections

To summarize our objections, FIA fears the bill would:

(1) increase the cost of hedging and price risk management for U.S. businesses, a bad result at any time, but one that is particularly harmful when those same businesses are struggling to cope with a deepening recession;

(2) increase price volatility by removing vital market liquidity through artificial limits or outright prohibitions on participation in regulated exchange trading and OTC transactions;

(3) disadvantage U.S. markets and firms by creating inadvertent incentives to trade overseas both exchange-traded and OTC derivatives; and

(4) weaken CFTC regulation by saddling the agency with responsibilities that would be resource-intensive to perform with little corresponding public benefit.

Our major concerns center on provisions in sections 6, 13 and 16 of the bill.

Section 6 would require the CFTC, under a cumbersome and costly advisory committee system, to impose fixed speculative position limits on all commodities traded on regulated exchanges. Today those limits are set by the exchanges for all non-agricultural commodities. No evidence exists that this position limit system has caused any market surveillance difficulties or failed to stop any market manipulation.

But the bill not only usurps the exchange's powers to set the limits, it would greatly expand the application of those limits by transforming into speculators many businesses that use futures in an economically appropriate manner to reduce price risks they face. Under the bill, any business becomes a speculator if its futures position is not a substitute for a transaction in the physical marketing channel or does not arise from a change in value in an asset or liability the business owns or service it provides.

Under this restrictive test, for example, automobile manufacturers will not be able to hedge gasoline prices. Yet gasoline prices often play a major role in determining what cars consumers will buy and, hopefully, manufacturers will make. No one will be able to use weather derivatives to hedge climate changes of any kind (weather is not in the physical marketing channel). Agribusinesses will be unable to hedge their foreign currency risk and airlines will be unable to hedge their interest rate risk. The list of increased, unmanaged (speculative) price risk to our economy goes on and on.

FIA understands that many Members of the Committee are concerned that speculation may have artificially influenced market prices in some commodities in the last year. We are still awaiting any objective fact-finding that would support that conclusion. For now, FIA has seen no evidence to distrust the market surveillance capabilities of the CFTC, especially when armed with the new special call reporting authority as the bill provides.

FIA does not believe that restricting the ability of businesses to hedge or manage price risks on regulated exchange markets is an appropriate response in any event. We do not believe it is sound economic policy to force businesses that want to use U.S. futures markets to manage their price risks to trade on overseas markets or enter into OTC derivative positions. FIA urges Chairman Peterson and the Committee to reconsider section 6.

Section 13 of the bill mandates clearing of all OTC derivative transactions, unless exempted by the CFTC under strict criteria. As the Committee well knows, all derivatives transactions involve counterparty credit risk. Different methods exist to deal with that risk. One of those methods is the futures-style clearing system.

FIA is a strong supporter of clearing systems. Clearing removes each party's risk that its counterparty may default. As I testified before the Committee in December, FIA's regular members—the clearing firms—provide the financial backbone for futures clearing. Our members guarantee the financial performance of every trade in the system.

FIA believes the futures clearing system works exceptionally well to remove counterparty risk and to reduce systemic risk. Increasing the number of transactions submitted for clearing also should be good for my members' bottom lines. In that sense, the Committee might expect FIA to support mandatory clearing of all OTC derivatives.

But we don't. While a clearing mandate may have some superficial appeal, FIA is concerned that section 13 could promote economic instability in the U.S. Most directly of concern to FIA clearing members, a mandate may force derivatives clearing organizations to clear OTC products that are not sufficiently standardized to be cleared safely. Not every derivative can be cleared. The DCOs will surely try to clear what they can clear, consistent with their risk management systems. But as the experience with CDS clearing shows, developing appropriate clearing systems takes time and an indiscriminate statutory mandate for immediate clearing of OTC products would add financial risk to clearing members as well as the financial system as a whole.

In addition, mandatory clearing of credit and other derivatives could lead to uncertainty in credit and other markets at a time when we are struggling to stabilize or restart those vital economic functions. It is true section 13 authorizes the CFTC to exempt classes of OTC derivatives from the clearing mandate. As drafted, however, section 13 would severely constrict the CFTC's ability to exempt OTC transactions.

FIA trusts the CFTC's experience and expertise. If clearing is to be mandated at all for any transactions, we believe the CFTC could craft a workable and specific exemption if the statutory exemption criteria are sufficiently flexible. We believe that flexibility will lead to the best national economic policy. Otherwise we fear mandatory clearing of OTC derivatives could trigger a rush to overseas OTC markets that would be counter-productive to our national economic interests.

FIA strongly supports one policy decision that is implicit in section 13. We know that some would mandate exchange trading of all derivatives in the U.S. FIA opposes that anti-competitive, anti-innovation approach and is pleased the draft bill does not go down that road. Consistent with section 13, FIA believes in an open, competitive system whereby classes of derivatives are first executed on exchange or dealer trading platforms as well as bilaterally and then submitted for clearing. Exchange and dealer competition for executing derivatives trades will serve well the interests of all market participants. FIA supports that approach.

Unlike section 13, the provisions of section 16 are anti-competitive and anti-innovation. It appears to ban so-called naked credit default swaps in OTC dealer markets (where all CDS transactions now occur), while allowing them on exchange markets (where today none occurs). In addition to the unfair competition feature of section 16, it would remove important liquidity from our credit markets and could operate to make credit itself more expensive for those in struggling businesses that now thirst for credit.

History teaches that removing liquidity provided by speculators leads to increased price volatility and costs for hedgers. Without speculators, hedgers may be forced to pay higher prices, rather than prices discovered by competitive market forces. The ban also would invite parties to the CDS market to conduct this business overseas, outside the jurisdictional reach of the U.S. financial regulatory system. That transactional exodus would complicate the job of Federal financial regulators, making it harder, if not impossible, to monitor systemic risk.

FIA understands Chairman Peterson's concern that trading in credit derivative swaps could add substantial counterparty credit risks to our economy. But developing and implementing appropriate clearing systems for these instruments should address that concern. In fact, section 13 of the bill is based on that premise. FIA believes the Committee should focus on improving the clearing provisions of section 13 of the bill, rather than banning liquidity providers from the CDS market or favoring exchanges over OTC dealers.

CFTC Regulation

FIA understands that Congress soon may receive proposals on financial market regulatory restructuring. In that regard, one aspect of the recent financial market turmoil must be highlighted. Despite unprecedented financial turbulence that has led to bankruptcies and bailouts, the U.S. futures markets have performed flawlessly. Fair and reliable prices have been discovered transparently. Hedgers have managed price risks in liquid markets. All trades have been cleared. Customers have been paid. Not a blip.

This record of excellence in an unprecedented crisis is the best evidence possible that the regulatory system this Committee has authored for decades works superbly well. It is also the best evidence that the Commodity Futures Trading Commission has done its job and done it well. This Committee should take pride in the record of the regulatory structures you put in place and the agency you created decades ago. Any efforts to rationalize Federal financial regulation should learn from the CFTC's example and make certain to preserve the best features of the futures regulatory system.

One feature of the current regulatory system that must be preserved is the exclusive jurisdiction of the CFTC over all facets of futures trading and related activities. Congress long ago determined that other Federal or state regulation should not duplicate or conflict with the CFTC's regulation of the futures markets. We know this

Committee has been vigilant in protecting this important public policy which has allowed CFTC-regulated futures markets to prosper for many years.

The decision by this Committee to establish an experienced and specialized agency to oversee U.S. futures markets also has worked well for decades. Yet, there is always talk that simply merging the CFTC into the SEC will cure all regulatory ills. FIA knows this Committee appreciates that such a merger would not promote the public interests served by the Commodity Exchange Act and would not resolve the public policy issues that have arisen out of the latest credit market stress. We thank the Committee for its leadership in this area.

Conclusion

FIA thanks Chairman Peterson and the Committee for this opportunity to share our views. We would be pleased to assist your deliberations in any way we can and to answer any questions you may have.

ATTACHMENT

Analysis of Derivatives Markets Transparency and Accountability Act of 2009

Section 3—Speculative Limits and Transparency of Off-Shore Trading

Section 3 has three subsections. FIA opposes the first subsection and supports the other two subsections which parallel provisions in H.R. 6604 passed by the House last year.

FIA supports coordinated market surveillance for linked products offered by competing U.S. and foreign exchanges. Last session, Rep. Moran offered legislation that would have addressed these issues in a comprehensive and reciprocal manner. FIA supports that approach. section 3(a), however, could spark retaliation by foreign regulators against U.S. firms and exchanges. The Moran approach is less likely to trigger that response and has broader application.

FIA supports subsections 3(b) and 3(c) which afford a safe harbor and legal certainty to CFTC-registered firms that execute or clear trades for customers on foreign exchanges even if those exchanges themselves do not comply with each and every CFTC requirement. U.S. firms should not be liable for any non-compliance by foreign exchanges. Last session, H.R. 6604 contained these provisions in a form that achieved the stated objectives. In the draft bill, important language has been inadvertently dropped from subsection 3(b). FIA would support the provision if the language from H.R. 6604 is restored.

Section 4—Detailed Reporting and Disaggregation of Market Data

Section 4 would add a new § 4(g) of the Commodity Exchange Act. FIA has no objection to having the CFTC define index traders and swap dealers. FIA also does not oppose monthly public reporting by the CFTC of the aggregate open positions held by index traders as a group and by swap dealers as a group using the data reported under the CFTC's large trader reporting system. FIA believes the CFTC also should consider other ways to make their Commitment of Trader Reports more granular and meaningful to all market participants.

FIA opposes requiring index traders and swap dealers to file "routine detailed" reports with the CFTC. (7:18) No other large traders—speculators or commercials—are subject to such a requirement. It should be sufficient to treat index traders and swap dealers that qualify as large traders like all other large traders for reporting purposes. FIA would also recommend the deletion of the language "in all markets to the extent such information is available." (8:11–12) The aggregate information included in the COT reports should be for futures and options positions only. Otherwise market participants that refer to the COT reports will receive a distorted view of the open interest and volume composition in futures and options markets.

Section 5—Transparency and Recordkeeping Authorities

Section 5 has three subsections.

Subsection 5(a) would require a CFTC-registered futures commission merchant, introducing broker, floor trader or floor broker to make reports and keep records as required by the CFTC for "transactions and positions traded" by those registered professionals or their customers in, generally, OTC derivatives transactions that are exempted from the CEA and CFTC rules. FIA does not object to giving the CFTC this authority but questions whether it is at least partially duplicative of the special call provisions provided in the second part of the section.

Subsection 5(b) has two parts. First, Subsection 5(b) would require any large trader of futures contracts in a commodity to maintain books and records of transactions and positions in that commodity which are otherwise generally exempt and excluded from the CEA. FIA does not object to this provision. Second, Subsection 5(b) would codify the CFTC's power to issue special calls for books and records relating to otherwise excluded or exempt transactions under the CEA when the CFTC determines it would be appropriate for market integrity purposes. FIA supports giving the CFTC this standby authority to enhance its market surveillance capabilities as circumstances require. Subsection 5(b) also requires large traders to retain the required books and record for 5 years. These required books and records shall include the "complete details" of all "such transactions, positions, inventories, and commitments, including the names and addresses of all persons having an interest therein." (10:8–12) FIA questions whether these statutory requirements are necessary or whether it would be preferable to grant the CFTC general authority to adopt appropriate record-keeping rules for large traders that engage in otherwise exempt or excluded transactions.

Subsection 5(c) contains conforming amendments to codify that the amendments in Subsections 5(a) and 5(b) create explicit exceptions to the statutory exclusions and exemptions in the CEA. FIA supports this legal certainty.

Section 6—Trading Limits to Prevent Excessive Speculation.

FIA opposes section 6. FIA sees no reason to repeal the exchanges' current authority to set position limits for their markets. (Today the CFTC sets position limits only for agricultural commodities.) The CFTC retains the power to review and amend any position limit set by an exchange if those limits are set in a manner that invites price manipulation or other market integrity concerns. Any member of the public is free to submit to the CFTC at any time a recommendation for changes to an exchange set position limit or accountability level. A formal advisory committee process is costly and unwarranted.

The major deficiency in section 6 is its restrictive hedging definition. If a business establishes a futures position "which is economically appropriate to the reduction of risks in the conduct and management of the commercial enterprise," that business is not a speculator. Instead, the business is managing an economic risk it faces in its business. Section 6 would misclassify that business as a speculator unless it also meets the "substitute transaction" and "change of held assets/liabilities" tests to become a physical hedger. These restrictions are bad economic policy and would impose unwarranted restrictions on businesses that want to use futures markets to hedge. Section 6 also would consider a swaps dealer to be a speculator if its futures positions are established to reduce the dealer's price risk on its net swaps position simply because some of its swaps counterparties are not physical hedgers. The swaps dealer is managing its price risk prudently and doing so in a transparent market through transactions without counterparty credit risk. That swaps dealer should be subject to all the market surveillance oversight faced by all large traders. But it should not be treated as a speculator because it is not speculating; it is trading futures to reduce its price risk in an economically appropriate manner.

Section 6 conflicts with the policy of promoting price risk management through exchange-traded and cleared markets. FIA strongly recommends that the Committee drop the hedging definition in section 6 and instead direct the CFTC to conduct a rulemaking to define, for position limit purposes, speculation, hedging and price risk management consistent with the public interests to be served by the CEA.

Section 7—CFTC Administration

FIA supports section 7's authorization of at least 200 new full time employees for the CFTC.

Section 8—Review of Prior Actions

FIA opposes requiring the CFTC to spend its resources reconsidering all of its currently effective regulatory actions as well as those of the exchanges to determine if they are consistent with the provisions of the bill. CFTC has not yet adopted regulations to implement the provisions enacted in the farm bill in 2008, which would enhance customer protection and market surveillance. Before reviewing past actions, FIA believes the CFTC should implement the farm bill's reforms. FIA appreciates that the CFTC is given no deadline for completing this "prior action" review. We are sure the CFTC will move expeditiously to implement this bill's regulatory provisions, if enacted, as well as the farm bill provisions from last year. The key is providing the CFTC with adequate resources to do the job and section 7 is an important step in this direction.

Section 9—Review of Over-the-Counter Markets

FIA does not oppose having the CFTC study eventually whether position limits should be imposed on exempt transactions in physically-based agricultural or energy commodities when those transactions are fungible with regulated futures contracts and significant price discovery contracts. FIA also does not oppose including in that study whether it would be good policy for the CFTC to adopt umbrella limits for futures, swaps and any other fungible transactions in such commodities. FIA would urge the Committee, however, to remove the deadlines and timelines for such studies. The CFTC should be able first to adopt and implement its rules for Significant Price Discovery Contracts as required in the 2008 Farm Bill. Then, after it has had experience with such rules, the CFTC could tackle the required study. At this point, it seems to be premature to study what contracts are fungible with SPDC contracts, especially where the CFTC has not yet implemented its SPDC authority.

Section 10—Study Relating to International Regulation of Energy Commodity Markets

FIA does not oppose having the Comptroller General study the international regime for regulating the trading of energy commodity futures and derivatives. Some of the terms used in the study outline should be clarified. For example, it is not clear what is meant by "commercial and noncommercial trading" (21:8–9). It is also not clear what constitutes "excessive speculation" (21:23–24) or "price volatility" (21:25). Last, the study contemplates a proper functioning market "that protects consumers in the United States." (22:34) The phrase suggests that markets should have a downward price bias to serve the interests of consumers. FIA instead believes that markets should reflect accurately market fundamentals, including the forces of supply and demand. FIA recommends that the Committee adjust the study outline to ensure it will provide beneficial, not skewed, results for further deliberations.

Section 11—Over-The-Counter Authority

FIA has no objection to having the CFTC analyze whether any exempt or excluded transaction is fungible with transactions traded on a registered entity, including an electronic facility that lists a Significant Price Discovery Contract. If such fungible contracts are found, and if the CFTC also finds that such contracts have the potential to harm the price discovery process on a registered entity, section 11 provides that the CFTC may use its existing emergency authority in section 8a(9) to impose position limits on such fungible contracts. This new authority would parallel the CFTC's new Significant Price Discovery Contract authority provided in the 2008 Farm Bill. As written, however, FIA can not support this provision. FIA is concerned about the breadth of the language "have the potential to" (22:24) harm market integrity on registered entities. The CFTC should be empowered to use these regulatory authorities only if it finds an actual emergency condition to exist which affects trading on registered entities. Otherwise the CFTC could use a mere possibility of an impact on a registered entity to restrain or prevent competition from arising among trading facilities or dealer markets with exchange markets. FIA also believes the Committee should make clear in section 11 that the CFTC should not apply its authority to restrict fair competition.

Section 12—Expedited Process

FIA has no objection generally to allowing the CFTC to use expedited procedures to implement the authorities in this bill if the CFTC deems it to be necessary. FIA does not believe the authority in section 12 itself is necessary because the Administrative Procedure Act provides the CFTC and other agencies with appropriate powers to expedite the kinds of rule making actions the bill contemplates. FIA does object to this provision if it is misread to authorize the CFTC to expedite and disregard APA or even Constitutionally-required procedural protections whenever the CFTC believes it to be necessary. That sweeping and standardless grant of authority could allow the agency to disregard well-established administrative procedural protections that have been adopted for many years to ensure reasoned and impartial agency decisions.

Section 13—Certain Exemptions and Exclusions Available Only for Certain Transactions Settled and Cleared Through Registered Derivatives Clearing Organizations

FIA supports encouraging market participants to clear appropriately standardized derivatives transactions. But FIA does not believe that mandatory clearing of all OTC derivatives is sound public policy. Clearing should only be available to those instruments that regulated clearing facilities decide they can safely clear. To date, no clearing facility believes it could or should clear **all** OTC derivatives. And even if a clearing facility believed it could clear a particular class or type of OTC derivative (and some do now), FIA would want that private entity's judgment confirmed by an expert Federal regulatory body, like the CFTC. FIA believes that clearing should be encouraged with incentives, not mandates, and only when the clearing entity and its government regulator agree that the particular class of OTC derivative could be submitted safely for clearing. Mandating clearing in a vacuum and without the necessary safety and soundness predicates, as section 13 appears to do, would be most unwise.

Section 13 does grant to the CFTC the authority to declare spot and forward contracts immune from the mandatory clearing requirement. (31:12–17) The CFTC's authority is appropriately broad and flexible. But given the structure of section 13 and the traditional meanings of the terms spot and forward contracts, FIA is uncertain whether most or all OTC derivatives could fall into the spot or forward category.

If not, the provisions in section 13 granting the CFTC the power to exempt classes of OTC transactions from the clearing mandate become particularly important. Unfortunately, the criteria in section 13 that would guide the CFTC's exemption decisions are much too rigid and constraining. As written, the CFTC would have to find a class of derivatives is "highly customized;" "transacted infrequently;" "serves no price discovery function;" and "being entered into by parties with demonstrated financial integrity." (29:23–30:9) It would be difficult, if not impossible, for the CFTC to craft an appropriate exemption under these mandatory criteria. The result would be that section 13 would operate as a ban on all non-cleared OTC derivatives transactions in the U.S. and an invitation to market participants to enter into OTC transactions outside the jurisdictional reach of the CEA. Removing that significant market liquidity and making transactions more opaque to U.S. regulators would be detrimental to the public interest. FIA strongly opposes section 13.

Section 14—Treatment of Emission Allowances and Off-Set Credits

FIA supports defining emission allowances and off-set credits as "exempt commodities" like all other energy-related commodities. Section 14, however, excludes these commodities from the "exempt commodity" definition and would treat them like agricultural commodities. FIA does not know of any public policy reason to constrain the development of market innovations, including multilateral electronic trading facilities or clearing, for trading in these instruments in these energy commodities. Achieving energy policy goals will require promoting and expanding innovation, not restricting it. The Committee should reconsider the policy implications of treating these energy commodities like agricultural commodities.

Section 15—Inspector General of the CFTC

FIA has no objection to creating the Inspector General of the CFTC as a Presidential appointment, subject to Senate confirmation. At the same time, we do not believe the absence of an IG appointed by the President is a weakness in the current CFTC structure.

Section 16—Limitation on Eligibility to Purchase a Credit Default Swap

FIA opposes the ban on naked credit default swaps. Section 16 will effectively terminate the U.S. CDS market and send it overseas. CDS transactions have fostered many economic benefits and it would be better to improve regulation and oversight of this market rather than jettisoning it to foreign shores.

FIA does support the provision that defines a credit default swap and allows registered entities that list for trading or clear CDS instruments to operate without having to comply with regulatory conditions imposed by the SEC. (38:1–9)

The CHAIRMAN. Thank you very much, Mr. Damgard.

Mr. Greenberger, welcome to the Committee.

STATEMENT OF MICHAEL GREENBERGER, J.D., PROFESSOR, UNIVERSITY OF MARYLAND SCHOOL OF LAW, BALTIMORE, MD

Mr. GREENBERGER. Thank you, Mr. Chairman.

Mr. Chairman, Ranking Member Lucas, first of all, I want to congratulate this Committee. It has been at the forefront of elucidating these issues by the many hearings it has held; and if you want to understand the problems either with speculation in the energy or agriculture markets or credit default, the problems with credit default swaps and its cause of the present meltdown, you only have to read the work of this Committee.

Second, Mr. Chairman, I want to congratulate you and then Ranking Member Goodlatte for the good work you did in the last

Congress. I know that bipartisanship is the mark of good legislation, especially with the advent of President Obama's emphasis on that. I congratulate you for having gotten the Transparency Act through by an over ⅔ vote, if I calculate correctly. I think you had 283 votes.

But, also, I want to congratulate you on something you yourself did not mention and you deserve a lot of credit for, and so does Ranking Member Goodlatte. On June 26th, on 1 day's notice, when gasoline prices were going over $4 and crude oil was approaching a world record high of $147, you on 1 day's notice with Ranking Member Goodlatte crafted legislation that passed on June 26th by a 402–19 vote that ordered the CFTC to immerse itself in those markets and use all its powers to drain any speculation, if it were there, in causing these problems.

Unfortunately, neither your June 26th bill, nor your September 18th bill was able to make its way through the Senate, but it was a model of aggressive leadership and bipartisanship, your doing that.

If this Committee wants the CFTC to stay as the principal regulator in this, it must work aggressively and it must demonstrate to the American people—and when I say "the American people," the industrial consumers of commodities are at this table, the farmers, the heating oil dealers, the gas station owners, the airlines are all very supportive of what you are doing and would ask for a little bit more in order to control these markets. And by that I talk about aggregated spec limits. I am not going to take time talking about it now, but that is something you should seriously consider.

With regard to your legislation, Mr. Damgard has worried about what Gerald Corrigan of Goldman Sachs testified to you are the, "bespoke," swaps transactions. Those are individually negotiated swaps transactions. Your bill has a broad exemption in there. Yes, the CFTC, after a public hearing, has to grant those exemptions, but this bill takes care of the nonstandardized but beneficial swaps transactions that need to be performed.

I would also say, when the airline industry is mentioned as suffering from this, I expect you will hear from the airline industry that it suffered substantially from the deregulation that it experienced over the last summer. So, yes, you have called for mandatory clearing, but you have an exemption in there. I would point out Senator Harkin, whose bill is tougher on the Senate side, does not allow for exemptions. Your bill does.

By the way, in 1993 the CFTC passed the so-called swaps exemption that allowed for tailored swaps to be marketed. Your exemption is broader than that, and I am of the opinion that the breadth you have articulated is needed. Naked credit default swaps have tripled—at least tripled the exposure to debt in these markets. It is one thing for there not to be enough money to pay, for example, for the subprime mortgages, but the naked credit default swaps allowed people to bet that those mortgages wouldn't be paid. As Eric Dinallo pointed out, New York's Insurance Superintendent who has responsibility for AIG and for MBIA, it tripled—the bets tripled the amount of money the American taxpayer must infuse into the financial system. I feel strongly that the ban on naked credit default swaps is important.

I identify myself completely with prior testimony of the Chairman of the Chicago Mercantile Group. I agree that the futures market is a beautiful market if it is properly policed. The swaps market was taken out of the jurisdiction of the CFTC. The Enron and London loopholes took agriculture and energy out of the CFTC. If they are put back into the CFTC, yes, the futures market is a wonderful market if you have good institutions like CME policing it and you have a strong CFTC overseeing those markets. And that is what your draft bill accomplishes. I would urge some minor tweaking, but it is a very good bill, and you are to be congratulated.

Thank you.

[The prepared statement of Mr. Greenberger follows:]

PREPARED STATEMENT OF MICHAEL GREENBERGER, J.D., PROFESSOR, UNIVERSITY OF MARYLAND SCHOOL OF LAW, BALTIMORE, MD

I want to thank this Committee for inviting me to testify on the important issue that is before it today.

I also want to congratulate and thank Chairman Peterson, Ranking Member Lucas, the whole Committee, and the Committee staff for the Committee's continuing hard work, thoughtful analysis, and leadership that it has brought to bear on the widespread concerns that the deregulated over-the-counter derivatives market has caused the most serious financial distress in the Nation's economy since the Great Depression.

Since the summer of 2008, this Committee has repeatedly taken the leadership on regulatory issues of greatest concern to the American people. When gas prices were reaching over $4.00 a gallon by the end of June 2008, this Committee drafted on a day's notice and supervised the June 26, 2008 passage by a vote of 402–19 emergency legislation that would have required the CFTC to implement emergency procedures in the crude oil futures markets to bring down the then sky rocketing price of gasoline, heating oil, and crude oil.[1] The Committee then drafted and supervised the passage by a 283–133 September 18, 2008 vote of the Commodity Markets Transparency Act of 2008, which was designed to bring transparency and accountability to the OTC energy markets, thereby stifling excessive speculation and unnecessarily high prices for America's energy needs.[2] Evidence adduced since the passage of this September 2008 legislation on the House floor has made it even clearer that excessive speculation in the unregulated energy and swaps markets has caused and continues to cause unnecessary and substantial volatility in the agriculture and energy markets.[3] On January 14, 2009, for example, it was reported that, "[b]etween Christmas [2008] and a week ago oil prices soared 40 percent, only to reverse almost as sharply in recent days."[4] "'The oil markets are suffering acute whiplash,' said Daniel Yergin, an energy consultant and author of 'The Prize,' a his-

1 David Cho, "House Passes Bill Bolstering Oil Trade Regulator", *Wash. Post,* June 27, 2008, at D8 available at *http://www.washingtonpost.com/wp-dyn/content/article/2008/06/26/AR2008062604005.html.*

2 Commodity Markets Transparency and Accountability Act, 110th Cong. (2008) available at *http://thomas.loc.gov/cgi-bin/bdquery/z?d110:HR06604:@@@R.*

3 Michael Masters, Adam White, *The Accidental Hunt Brothers* (July 31, 2008) available at *http://accidentalhuntbrothers.com/* (stating "[t]he total open interest of the 25 largest and most important commodities, upon which the indices are based, was $183 billion in 2004. From the beginning of 2004 to today, Index Speculators have poured $173 billion into these 25 commodities."); Maher Chymaytelli, *Opec Calls for Curbing Oil Speculation, Blames Funds,* January 28, 2009, available at *http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aw4VozXUOVwU* (stating "Oil surged 46 percent in the first half of 2008 to a record $147.27 only to plunge by the end of the year. So-called net-long positions in New York crude futures by hedge funds and other large speculators betting on higher prices peaked at 115,145 contracts in March, according to data from the CFTC. They switched direction in July to a net-short position, or wager against prices, which reached 52,984 contracts by mid-November, the CFTC data show. Oil futures traded 6¢ down at $41.52 a barrel on the New York Mercantile . . . down 72 percent from last year's record."); *The Price of Oil.* (January 11, 2009). CBS: 60 MINUTES.

4 Clifford Kraus, *Where Is Oil going Next,* NEW YORK TIMES (January 14, 2009) B1 at *http://www.nytimes.com/2009/01/15/business/worldbusiness/15oil.html.*

tory of world oil markets. 'Price volatility is adding to the sense of shock and confusion and uncertainty.' "[5]

From October through December 2008, this Committee has held a highly productive, informative and widely publicized series of hearings on the role unregulated over-the-counter ("OTC") financial derivatives have played in causing the present economic meltdown. Now, under the leadership of Chairman Peterson, a new and comprehensive discussion draft of the Derivatives Markets Transparency and Accountability Act of 2009, has been circulated for comment and is the subject of today's hearings. Again, that draft legislation is designed to apply time-tested tools of market regulation to the OTC agriculture, energy and financial derivatives markets.

There can be little doubt that the overwhelming message of the testimony presented to this Committee in its hearings on OTC derivatives has largely established a consensus that the previously unregulated OTC markets have caused severe systemic economic shocks to the economy, because of a lack of transparency to the nation's financial regulators of these private bilateral agreements, and because of inadequate capital reserves set aside by OTC derivative counterparties to underpin the trillions of dollars of financial commitments they made (and are now owed) through the OTC transactions in question.

In almost all the credit markets examined, the derivative transactions have increased exponentially the risk and resulting indebtedness within the underlying markets. For example, New York Insurance Superintendent, Eric Dinallo, who has been responsible for overseeing two major troubled financial institutions that come within his regulatory ambit (AIG and MBIA), has demonstrated that outstanding credit default swaps ("CDS") "could total three times as much as the actual debt outstanding" in the markets for which the CDS provide guarantees.[6] In other words, because of "naked" credit default swaps that provide payouts to counterparties who have no interest insurable risk emanating from debts within these markets (*i.e.,* they are simply wagering, for example, in exchange for a relatively small insurance-like premium, that subprime mortgages will not be paid off), the actual billions of dollars of losses in these markets have been magnified three fold by rampant and uncontrolled "betting" on these markets.[7]

By virtue of bailouts, guarantees, and loans (*e.g.,* the FED exchanging Treasuries at its discount window for banks' troubled subprime assets) made by the United States Treasury and/or the Federal Reserve, the American taxpayer has been required to make good on unfulfilled or potentially unfulfilled commitments of our largest financial institutions in the OTC derivatives market of up to $6 trillion.[8] With the advent of the stimulus legislation and President Obama's soon to be announced overarching financial package, the American public's outlay will doubtless soon grow by further trillions of dollars through further possible guarantees, purchases of troubled assets (*i.e.,* a "bad bank"), mortgage and other loans, and further capital infusions into the financial system.

Of course, the subject of today's hearing does not, and cannot, address the present multi-trillion dollar "hole" in our economy, which, in turn, has brought the world markets to their knees. This hearing and the legislation to which it is addressed is forward looking. The underlying thesis here is: if we are fortunate enough to dig ourselves out of the huge financial mire in which we find ourselves, a regulatory structure must be put in place that will prevent the risk creating and risk bearing folly that led to the present fiasco.

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[5] *Id.*

[6] *The Role of Financial Derivatives in the Current Financial Crisis: Hearing before the Senate Agricultural Comm.,* 110th Cong. at 3 (October 14, 2008) (written testimony of Eric Dinallo, Superintendent, New York State Insurance Dept.) available at *http://www.ins.state.ny.us/speeches/pdf/sp0810141.pdf.*

[7] *The Role of Financial Derivatives in the Current Financial Crisis: Hearing before the Senate Agricultural Comm.,* 110th Cong. (October 14, 2008) (stating "by 2000 we engaged in the Commodities Futures Modernization Act, which specifically did a few things. It made credit default swaps not a security, so it couldn't be regulated as a security; as you said, put it out of reach of the CFTC; and it said this act shall supersede and preempt the application of any state or local law that prohibits or regulates gaming or the operation of bucket shops.")

[8] David Leonhardt, *The Big Fix,* N.Y. TIMES (February 1, 2009), (stating that "the debt that the Federal Government has already accumulated [. . .] is equal to about $6 trillion, or 40 percent of G.D.P. [. . .] The bailout, the stimulus and the rest of the deficits over the next 2 years will probably add about 15 percent of G.D.P. to the debt. That will take debt to almost 60 percent, which is above its long-term average but well below the levels of the 1950s. But the unfinanced parts of Medicare, the spending that the government has promised over and above the taxes it will collect in the coming decades requires another decimal place. They are equal to more than 200 percent of current G.D.P.")

I have appended hereto a paper I prepared that outlines the severe damage unregulated OTC derivatives have caused to the market and that proposes a generic regulatory program designed to apply traditional and time tested tools of regulatory oversight now governing our equity, debt and regulated futures markets to our OTC derivatives markets. Suffice it to say, that I am in agreement with many who have already come before this Committee and the Senate Agriculture Committee on these issues, including Terrence A. Duffy, Executive Chairman of the CME Group, Inc.;[9] Eric Dinallo (the New York Insurance Superintendant);[10] Professor Henry Hu, Professor of Law at the University of Texas Law School;[11] Professor William K. Black of the University of Missouri-Kansas City;[12] and Erik Sirri, Director of SEC's Division of Trading and Markets[13] as to the regulation of financial OTC derivatives; and Adam K. White, CFA,[14] and PMAA's witnesses as to agriculture and energy OTC derivatives. Former Chair of the Federal Reserve, Paul Volker, has elsewhere made recommendations and observations consistent with the above referenced testimony,[15] as has the January 29, 2009 Special Report on Regulatory Reform of the Congressional Oversight Panel mandated by the Emergency Economic Stabilization Act of 2008 ("the bailout legislation").[16] Finally, former SEC Chair Arthur Levitt has recommended reversal of the deregulatory effects of 2000 Commodity Futures Modernization Act on the OTC markets,[17] and even former Fed Chair Alan Greenspan has admitted that it was an error to deregulate the credit default swaps market.[18]

I am pleased that the draft legislation that we discuss today adopts most of the points made in my appended paper and the recommendations of the witnesses I have cited above.

In this regard, I support Discussion Draft's:

1. Requirement of mandatory clearing of OTC derivatives both through the CFTC or other appropriate Federal financial regulators and by the CFTC exclusively in the energy and agriculture markets.

2. Reporting requirements and regulatory oversight obligations placed on designated clearing organizations ("DCOs").

3. Tailored, precise, and limited exemptions that may be granted by the CFTC to the mandatory clearing requirements for individually negotiated or, in the words of Goldman Sachs' E. Gerald Corrigan, "bespoke" derivatives, *i.e.,* derivatives that by the instrument's limited reach and their unsuitability for trading cannot cause systemic risk to the nation's economy.

4. Imposition of speculative limits for noncommercial trading on designated contract markets ("DCMs"), designated transaction execution facilities ("DTEFs") and on other electronic trading facilities, as well as foreign boards of trade, especially insofar as those speculation limits are recommended by Position Limit Advisory Groups composed in significant part by commercial hedgers within the

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[9] *The Role of Credit Derivatives in the U.S. Economy:* Hearing Before the House Comm. on Agriculture, 110th Cong. (December 8, 2008).

[10] *The Role of Credit Derivatives in the U.S. Economy: Hearing Before the House Comm. on Agriculture,* 110th Cong. (November 20, 2008).

[11] *The Role of Credit Derivatives in the U.S. Economy: Hearing Before the House Comm. on Agriculture,* 110th Cong. (October 15, 2008).

[12] *Role of Financial Derivatives in Current Financial Crisis: Hearing Before Senate Agricultural Comm.,* 110th Cong. (October 14, 2008).

[13] *The Role of Credit Derivatives in the U.S. Economy: Hearing Before the House Comm. on Agriculture,* 110th Cong. (November 20, 2008).

[14] *To Review Legislation Amending the Commodity Exchange Act: Hearing Before the House Comm. on Agriculture, 110th Cong.* (July 10, 2008).

[15] Paul A. Volcker, Address to the Economic Club of New York, at 1–2 (April 8, 2008) available at *econclubny.org/files/Transcript__Volcker__April__2008.pdf*).

[16] CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., SPECIAL REPORT ON REGULATORY REFORM: MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM: RECOMMENDATIONS FOR IMPROVING OVERSIGHT, PROTECTING CONSUMERS, AND ENSURING STABILITY (2009).

[17] Goodman, *The Reckoning: Taking Hard New Look at a Greenspan Legacy,* N.Y. TIMES (October 9, 2008) available at *http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html?pagewanted=1&__r=1;* Michael Hirsh, *The Great Clash of '09: A looming battle over re-regulation,* NEWSWEEK, (December 24, 2008) available at *http://www.newsweek.com/id/176830.*

[18] CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., SPECIAL REPORT ON REGULATORY REFORM: MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM: RECOMMENDATIONS FOR IMPROVING OVERSIGHT, PROTECTING CONSUMERS, AND ENSURING STABILITY. (2009) at 7 (quoting former Federal Reserve Chairman Alan Greenspan "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief."

relevant markets, *i.e.*, those who have intimate knowledge of the degree of speculation needed in each market to provide liquidity.

5. Establishment of a clear and concise definition of a "*bona fide* hedging transaction" limiting that exclusion from speculation limits to those actually engaged as a primary business activity in the "physical marketing channel" of the commodity.

6. Imposition of three additional core principles to the criteria for establishing of a designated clearing organization ("DCO"): (1) disclosure of general information; (2) publication of trading information; and (3) fitness standards.

7. "Transition rule" requiring existing uncleared swaps or uncleared swaps executed for the period after enactment to establish the regulatory scheme to be required by the statute to be reported to the CFTC.

8. The banning of "naked" credit default swaps, *i.e.,* those swaps that are merely a wager on the viability of an institution or financial instrument without requiring the corresponding underlying risk from the failure of those institutions or instruments.

9. The creation of an independent CFTC Inspector General confirmed by the Senate.

10. The appointment of at least 200 new full time CFTC employees.

With regard to my comments in support of the draft legislation, I want to particularly call attention to two commendable aspects of the legislation.

1. *The ban on "naked" credit default swaps.* Former SEC Chairman Christopher Cox has since September 2008 repeatedly criticized these instruments as "naked" shorts on public corporations that evade the requirements for shorting stocks in the regulated equity markets.[19] He and the New York Insurance Superintendent, Eric Dinallo, have warned that these instruments encourage the "moral hazard" of providing perverse incentives to take actions that cause companies covered by the CDS to fail or, in the case of naked short of subprime mortgage paper, borrowers to default on their mortgage loans.[20] As to incentives of undercut the mortgage backed paper, *i.e.,* mortgage backed securities or collateralized debt obligations, that has led many holders of CDS guarantees to oppose, for example, mortgage workouts so that mortgage defaults trigger "naked" CDS payments. Chairman Peterson had it exactly right when he recently said: "'It is hard for me to understand what useful purpose these things are serving, . . . I'm not out to get Wall Street, but what's gone on there is jeopardizing the world economy.'"[21] Those who support "naked" CDS argue that it is needed for "price discovery." However, the reported "short interest" on public companies in the regulated equities market already is an adequate "price discovery mechanism" for the worth of those companies. For price discovery on CDS guarantees of collateralized debt obligations, those CDS that insure actual risk on CDO investments should serve any needed price discovery function; to the extent that "real" CDS are inadequate for that purpose, the undisputed harm done to the economy by "naked" CDS far outweighs any price discovery benefits from allowing the continued trading of "naked" CDS. Had "naked" CDS been banned in the passage of the CFMA in 2000, it is my firm belief that there would have been no need for this hearing today in that the outlawing of that product, in and of itself, would have substantially mitigated the worldwide financial meltdown we are now experiencing.

2. *Mandatory Clearing.* While the financial services industry has supported the "availability" of clearing OTC derivatives as a "firewall" against systemic risk, they have, for the most part, opposed mandatory clearing. As has been explained in testimony by the CME Group, for example, a clearing facility, which is guaranteeing the performance of both counterparties to an OTC derivative

[19] O'Harrow and Denis, *Downgrades and Downfall,* WASHINGTON POST (December 31, 2008) A1 (stating "'The regulatory blackhole for credit-default swaps is one of the most significant issues we are confronting on the current credit crisis,' Cox said, 'it is requires immediate legislative action.'").

[20] *The Role of Financial Derivatives in the Current Financial Crisis: Hearing before the Senate Agricultural Comm.*, 110th Cong. 3 (October 14, 2008) (opening statement of Eric Dinallo, Superintendent, New York State Insurance Dept.) (stating "We engaged in the ultimate moral hazard . . . no one owned the downside of their underwriting decisions, because the banks passed it to the Wall Street, that securitized it; then investors bought it in the form of CDOs; and then they took out CDSs. And nowhere in that chain did anyone say, you must own that risk.").

[21] Matthew Leising, *Bloomberg.com,* "Peterson Plans Bill to Force Credit Default Swaps Clearing" (December 15, 2008).

contract, can only assume that substantial risk for performance for those contracts about which it has complete understanding. The requirement to understand contractual risk, *inter alia,* requires that the OTC cleared contracts be standardized, *i.e.,* so that the clearing facility has substantial comprehension of the guarantor role it is playing. Those who oppose mandatory clearing worry about the inability to clear non-standardized OTC derivatives. As far back as 1993, however, the CFTC has promulgated a "swaps" exemption for individual negotiated swaps agreements that are not executed on an electronic trading facility.[22] Moreover, the draft legislation provides an arguably broader "individualized" exemption with the corresponding precise standards that assure that the exemption will only be granted when systemic risks will not be posed. In short, the draft legislation is a reasonable compromise that accommodates individually negotiated contracts that cannot be cleared. It should also be born in mind that the Senator Harkin's legislation flatly bans exceptions from his requirement that all OTC contracts be exchange traded—not merely cleared.[23] In this regard, the New York Stock Exchange has just advocated that "U.S. policy makers should extend existing [exchange] rules so that they apply to unregulated derivatives instead of drafting new legislation that may take years to implement, . . ." [24]

My only questions and/or comments on the draft legislation are:

1. *Express Pre-approval Findings of Suitability of Designated Clearing Organizations.* The CFMA sets out 14 core principles for the establishment of a DCO. As mentioned above, the discussion draft adds three new core principles borrowed from the core principles applicable to designated transaction execution facilities DTEFs (*i.e.,* non-retail exchange trading for high net work institutions and individuals). However, as made clear by the CFTC's Director of Clearing and Intermediary Organizations, Ananda Radhakrishnan, under the Commodity Exchange Act, "DCOs do not need pre-approval from the CFTC to clear derivatives, [but] any such initiative would be required to comply with the relevant core principles set forth in the [statute] and the CFTC would review it for compliance with those principles. . . ." [25] In other words, the statute allows facilities to self certify as DCOs and the CFTC would only then examine compliance with core principles after the fact. As is now well known, the CFTC "announced" on December 23, 2008 that "the CFTC staff would not object to the [DCO] certification." [26] The CME submitted its plans to the CFTC staff prior to the operation of its DCO. The "CFTC staff reviewed CME's plans to clear credit default swaps, including CME's planning risk management procedures, . . ." [27] My search of the CME docket number on the CFTC website shows no accompanying order by the Commission or the CFTC staff indicating or explaining such approval. I hasten to add that I have little doubt about the qualifications (or indeed the great benefit) of the CME, the world's largest derivatives exchanges, engaging in this clearing. However, others are eligible to apply for DCO status and in an age when the American public is clamoring for transparency in governmental actions, especially actions surrounding the present financial crisis, and given the great importance of approving an institution to clear these highly volatile and potentially toxic products, it would seem that pre-approval of a clearing facility should be required and that the Commission—not just the staff—should issue affirmative and detailed findings about its confidence in the applicant serving as a DCO. Indeed, prior to the passage of the CFMA in December 2000, the CFTC and its staff issued 18 single space pages of detailed findings endorsing the safety and soundness of the first appli-

[22] 17 C.R.F. Part 35 (1993).

[23] *The Derivatives Trading Integrity Act,* 111th Cong. (January 15, 2009); Senate Agriculture Comm., Statement of Chairman Tom Harkin: Role of Financial Derivatives in the Current Financial Crisis (Oct. 14, 2008); Posting of James Hamilton to Jim Hamilton's World of Securities Regulation, *http://jimhamiltonblog.blogspot.com/2009/01/senate-bill-would-regulate-otc.html* (Jan. 17, 2009, 14:58) (stating "[t]he broad goal of the [Senator Harkin's] legislation is to establish the standard that all futures contracts trade on regulated exchanges.").

[24] Lisa Brennan, "Exchange Rules Should Apply to Derivatives, NYSE Says" (*Bloomberg*, February 2, 2009).

[25] *The Role of Financial Derivatives in the Current Financial Crisis: Hearing before the Senate Agricultural Comm.,* 110th Cong. 3 (October 14, 2008).

[26] Press Release, Commodity Futures Trading Commission, *CFTC Announces That CME Has Certified a Proposal to Clear Credit Default Swaps* (Dec. 23, 2008) available at *http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5592-08.html.*

[27] *Id.*

cant to clear swaps.[28] Since the CFTC staff checks the safety and soundness of a DCO one way or another, the Committee should add a provision to the legislation requiring pre-approval of DCOs trading OTC derivatives and that that pre-approval be accompanied by findings demonstrating that the DCO applicant meets all applicable statutory requirements. Given the importance of the clearing facility in serving as a firewall against breakdown of the economy, it seems a small burden to require a transparent Commission document reflecting its careful attention this important decision.

2. *Fraud and Manipulation.* As the CFMA is presently drafted, the swaps exemption in section 2(g) of the Act excludes swaps from the anti-fraud and anti-manipulation provisions within the statute.[29] (This exclusion distinguishes itself from "exempt" commodities, *e.g.,* energy futures, which are subject to the Act's fraud and manipulation prohibitions.) Senator Harkin's legislation, S. 272, by requiring the exchange trading of swaps and the elimination of "exemptions" and "exclusions" brings the swaps market within the umbrella of the Act's central fraud and manipulation prohibitions. As Patrick Parkinson (Deputy Director, Division of Research and Statistics of the Federal Reserve System) made clear in his November 20, 2008 testimony before this Committee, the President's Working Group on Financial Markets is advising that OTC clearing facilities qualifications be measured against the "Recommendations for Central Counterparties" of the Committee on Payment and Settlement Systems of which Mr. Parkinson was the Co-Chair and on which the CFTC and SEC served.[30] Those recommendations are replete with concerns about combating fraud in the clearing process. In the present climate of American public's distrust of financial markets, OTC swaps, as is true of "exempt" futures, should be subject to fraud and manipulation prohibitions. Moreover, it would seem to be a difficult argument to make that, whereas swaps should be cleared, fraud and manipulation should not be barred or, conversely, that logic would seem perversely to dictate that fraud and manipulation be permitted.[31]

3. *Important Inconsistency between sections 6 and 9 of the Discussion Draft.* As I read section 6(2)(A) of the Discussion Draft, it requires that the CFTC "shall . . . establish limits on the amount of positions, as appropriate, other than *bona fide* hedge[rs] that may be held by any person with respect to . . . commodities traded . . . on an electronic trading facility as a significant price discovery contract." Section 6(B)(i) and (iii) mandate that these limits "shall be established" within set time periods for "exempt commodities" and "excluded commodities." Exempt commodities include over-the-counter energy futures contracts exempt from regulation by § 2(h) of the CEA. Excluded commodities cover swaps are exempt under § 2(g). Therefore, it would seem that section 6 of the Discussion Draft mandates the imposition of position limits on OTC "exempt" and "excluded" trading. Moreover, section 6 seems, by the breadth of its language, to authorize implicitly the CFTC to impose aggregated limits across contract markets for specified commodities. On the other hand, section 9, by its terms, appears to require the CFTC to "study" each of these issues already addressed in section 6 and to report back to this Committee within 1 year of enactment. Given the overwhelming evidence that has been gathered about the impact of excessive speculation on the energy futures and energy swaps markets,[32] for example, section 9 should be struck from that statute, because the time for study has long since passed. Moreover, I would urge this Committee

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[28] Order Granting the London Clearing House's Petition for an Exemption Pursuant to Section 4(c) of the Commodity Exchange Act, 64 *Fed. Reg.* 53346–64 (October 1, 1999).

[29] Johnson & Hazen, Derivatives Reg., section 1.18[6][B] at p. 332 (2004 ed.) "[U]nlike excluded transaction, with exempt off-exchange transactions [, exempted transactions and swaps transactions], the CFTC retains its enforcement authority in case of fraud or market manipulation." Interpretation of CEA §§ 2(c), 2(d) and 2(g).

[30] Patrick M. Parkinson, Statement of Testimony before the Committee on Agriculture United States House of Representatives on November 20, 2008, he stated that "We [the CFTC, SEC, and Federal Reserve] have been jointly examining the risk management and financial resources of the two organizations that will be supervised by U.S. authorities against the 'Recommendations for Central Counterparties,' a set of international standards that were agreed to in 2004 by the Committee on Payment and Settlement Systems of the central banks of the Group of 10 countries and the Technical Committee of the International Organization of Securities Commissions," available at *http://agriculture.house.gov/testimony/110/h91120/Parkinson.pdf.*

[31] [No citation in submitted testimony.]

[32] *Supra* at n. 3.

to follow the bipartisan lead of Senators Reid, Lieberman and Collins[33] and require—not simply authorize—the CFTC to impose aggregated speculation limits upon U.S. traders and those trading in the U.S. across the energy and agriculture contract markets. It should be emphasized that on July 26, 2008 [check date] the Reid bill garnered 50 of 93 Senate votes in the last Congress in an unsuccessful attempt to sustain cloture in the last Congress.[34] Again, given the heightened evidence of excessive speculation in the crude oil markets that post-date that July 26th vote, it could be expected that the 60 votes needed to bring the Reid aggregate spec limits bill to a vote on the merits will be reached in this Congress. My understanding is that this Committee will receive testimony from a broad coalition of industrial consumers of energy, including the airlines, truckers, farmers, heating oil dealers, and petroleum marketers, strongly backing the inclusion of aggregated spec limits for energy and agriculture in any bill reported out by this Committee.

4. *Standards for Approving a Designated Clearing Organization.* As stated above, I support the Discussion Draft's addition of three core principles to the statute's 14 criteria governing the approval of DCOs. I have also recommended above that the Commission—and not just the CFTC staff—make detailed pre-approval findings that the applicant for DCO status meets the criteria for clearing OTC derivatives. Again, the approval process is critical because it is universally recognized that a "risk management failure by a [clearing facility] has the potential to disrupt the markets it serves and . . . [cause] disruptions to securities and derivatives markets and to payment and settlement systems, . . ." A mistaken decision by the CFTC about the appropriateness of an applicant to serve as a DCO will simply recreate the instability of the present system where counterparties—even counterparties rated AAA at the commencement of the derivatives transactions—were ultimately downgraded and not able to fulfill their contractual obligations. The DCO approval decision requires great sophistication. Three years ago, many then AAA rated institutions, such as Lehman, Bear Stearns, or AIG, would have very likely been deemed strong DCO candidates. In short, today's AAA rated institution may be tomorrow's undercapitalized and overwhelmed entity whose failure will undermine the OTC derivatives settlement process; and possibly the Nation's economy as a whole. The Fed's and the SEC's reliance, for example, on the intricately detailed CPSS's "Recommendation for Central Counterparties," raises the question whether the CFMA's generalized DCO approval criteria—even as supplemented by the Discussion Draft's three additional criteria—are detailed enough to ensure that only the most prudent and stable entities to clear OTC derivatives. If the CPSS's recommendations are more thorough in this regard (they are certainly more detailed), adoption of the CPSS's standards by other Committees of Congress for their regulators, may become a pretext to seek the removal of the CFTC from clearing approval authority. The CPSS recommendations should be studied to ensure that that the DCO criteria are complete.

It is for that reason that my preference would be to adopt exchange trading criteria to OTC derivatives as is required by S. 272. The New York Stock Exchange has also recently supported an exchange based approach.[35] The statutory requirements for a designated transaction execution facility are more rigorous than those for a DCO even as those DCO criteria are upgraded by the discussion draft. DCOs are not expressly required to establish net capital requirements or financial integrity standards for counterparties;[36] there is no regulation of DCO intermediaries as

[33] See S. 3044, "Consumer-First Energy Act", 110th Congress, Sponsored by Sen. Henry Reid. See Also S. 3248, "Commodity Speculation Reform Act", 110th Congress, Sponsored Sen. Joseph Lieberman, Sen. Christopher Bond, Sen. Maria Cantwell and Sen. Susan Collins.

[34] Record Vote Number: 146, 110th Congress (June 10th, 2008). Cloture motion rejected—51 Yeas, 43 Nays, 6 Not voting. The four supporting republicans were, Collins (R–ME), Smith (R–OR), Snowe (R–ME) and Warner (R–VA).

[35] *Supra* at n. 24.

[36] *Compare* 7 U.S.C. § 7a(b)(3)(B)(iv) (2008) (stating the minimum net capital requirements for a party to trade on a registered DTEF) and 7 U.S.C. § 7a(c)(4) (2008) (mandating that DTEF boards of trade must "establish and enforce rules or terms and conditions providing for the financial integrity" of both participants and transactions entered on or through the board of trade) *to* 7 U.S.C. § 7a–1(c)(2)(C)(i) (2008) (merely requiring "appropriate minimum financial requirements" for admission and continued eligibility, but providing no explicit standards).

[37] Intermediaries, such as futures commission merchants, depository institutions, and Farm Credit System Institutions, must meet certain requirements in order to interact with a DTEF. 7 U.S.C. § 7a(e)(1) (2008). The intermediary must be in good standing with the SEC or the Federal bank regulatory agencies (whichever is appropriate. 7 U.S.C. § 7a(e)(2)(A) (2008). Addition-

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is true in the case of DTEFs;[37][38] unlike DTEFs, the emergency authority of a DCO is expressly limited to withstanding "disasters" which in context of the statute is appears to be limited to natural disasters or Y2K types of information technology problems and not the threat of a systemic meltdown of the facility as a whole;[39] and there is no requirement for self regulation of DCOs as is true of DTEFs.[40] Finally, while it is true that DTEFs, unlike Designated Contract Markets ("DCM"), do not expressly have to establish dispute resolution mechanisms, this would be a worthy requirement to be applied to DCOs dealing with the highly volatile OTC derivatives markets.[41]

In sum, the Committee should be congratulated for the scope of its hearings on these critically important questions and for the thoroughness of the Discussion Draft.

APPENDIX A

Memorandum on Regulatory Reform of Credit Default Swaps

January 24, 2009

PROFESSOR MICHAEL GREENBERGER.

While a litany of factors including lending and financial abuses led to the present economic meltdown, chief among them was the opaque nature of the estimated notional $596 trillion[1] unregulated over-the-counter derivatives market. That market includes what is estimated to be the $35–$65 trillion credit default swaps ("CDS") market.[2] The over-the-counter derivatives market was, prior to December 20, 2000, conventionally understood to be subject to regulation under the Commodity Exchange Act ("CEA"). On that date, the Commodity Futures Modernization Act ("CFMA") was passed. That legislation was, for the most part, rushed through Congress and enacted during a lame duck session as a rider to an 11,000 page omnibus appropriation bill.[3] That statute removed swaps transactions from all meaningful Federal oversight.

In warning Congress about badly needed reform efforts when it considered the bailout legislation in Senate hearings before the Senate Banking Committee in September, 2008, SEC Chairman Christopher Cox called the CDS market a "regulatory blackhole" in need of "immediate legislative action."[4] Former SEC Chairman Arthur

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ally, if the intermediary holds customer funds for more than a day, it must be registered as futures commission merchant and must be a member of a registered futures association. 7 U.S.C. § 7a(e)(2)(B) (2008). There is no statutory equivalent for DCOs concerning FCMs, depository institutions Farm Credit Institutions, or any other type of intermediary. *See generally* 7 U.S.C. § 7a–1 (2008).

[38] *See* 7 U.S.C. § 7a(d)(7) (2008) (stating that "the board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members, and any other persons with direct access to the facility, including any parties affiliated with any of the persons described in this [statute]."). There is no comparable requirement for DCOs. *See generally* 7 U.S.C. § 7a–1 (2008).

[39] 7 U.S.C. § 7a–1(c)(2)(I)(ii) (2008) (requiring the maintenance of emergency procedures, a disaster recovery plan, and periodic testing of backup facilities, but not the establishment of a contingency plan to deal with economic emergencies).

[40] While both DTEFs and DCOs have various requirements that they are responsible for carrying out, it is only in the context DTEFs that the concept of "self regulation" is expressly addressed. *See* 7 U.S.C. § 7a(b)(2)(E) (2008) (noting that the Commission will consider the entities history of this self regulation when determining if there is a threat of manipulation); *see, e.g.,* 7 U.S.C. § 7a(d)(2008) (explaining the core principles and explicit duties of a DTEF); 7 U.S.C. § 7a–1(c)(2) (2008) (listing in broad terms the responsibilities of a DCO).

[41] However, it is worth noting that:

> a board of trade may elect to operate as a registered derivatives transaction execution facility if the facility is—
>
> (1) designated as a contract market and meets the requirements of this section; or
>
> (2) registered as a derivatives transaction execution facility under subsection (c) of this section.

7 U.S.C. § 7a(a)(1)–(2) (2008).

If the DTEF chose to operation under section (1), it follows that the board of trade would be obligated to follow all of the requirements for a DCM.

[1] *See,* Bank for International Settlements, BIS Quarterly Review (September, 2008), available at *http://www.bis.org/publ/qtrpdf/r_qa0809.pdf#page=108.*

[2] *Id.*

[3] *See, e.g.,* Johnson & Hazen, Derivatives Regulation, § 1.17 at 41–49 (2009 Cum. Supp.)

[4] "'The regulatory blackhole for credit-default swaps is one of the most significant issues we are confronting on the current credit crisis,' Cox said, 'it is requires immediate legislative ac-

Levitt and even former Fed Chair Alan Greenspan have acknowledged that the deregulation of the CDS market contributed greatly to the present economic downfall.[5]

In brief, the securitization of subprime mortgage loans evolved from simple mortgage backed securities ("MBS") to highly complex collateralized debt obligations ("CDOs"), which were the pulling together and dissection into "tranches" of huge numbers of MBS, theoretically designed to diversify and offer gradations of risk to those who wished to invest in that market. However, investors became unmoored from the essential risk underlying loans to non-credit worthy individuals by the continuous reframing of the form of risk (*e.g.,* from mortgages to MBS to CDOs); the false assurances given by credit rating agencies that gave misleadingly high evaluations of the CDOs; and, most importantly, by the "insurance" offered by CDO issuers in the form of CDS. The CDS "swap" was the exchange by one counterparty of a premium for the other counterparty's "guarantee" of the financial stability of the CDO. While CDS has all the hallmarks of insurance, issuers of CDS were urged not to refer to it as "insurance" out of a fear that CDS would be subject to insurance regulation by state insurance commissioners. By using the term "swaps," CDS fell into the regulatory blackhole afforded by the CFMA.

Because CDS was not insurance or any other regulated instrument, the issuers of CDS were not required to set aside adequate capital reserves to stand behind the guarantee of the financial stability of CDOs. The issuers of CDS were beguiled by the utopian view (supported by ill considered mathematical algorithms) that housing prices would always go up and that, even a borrower who could not afford a mortgage at initial closing, would soon be able to extract that appreciating value in the residence to refinance and pay mortgage obligations. Under this utopian view, the writing of CDS was deemed to be "risk free" with a goal of writing as many CDS as possible to develop cash flow from the "premiums."

To make matters worse, CDS was deemed to be so risk free (and so much in demand) that financial institutions began to write "naked" CDS, *i.e.,* offering the guarantee to investors who had no risk in any underlying mortgage backed instruments or CDOs. Naked CDS provided a method to "short" the mortgage lending market, *i.e.,* to place the perfectly logical bet for little consideration (*i.e.,* the premium) that those who could not afford mortgages would not pay them off. The literature surrounding this subject estimates that more "naked" CDS instruments are extant than CDS guaranteeing actual risk.

Finally, the problem was further aggravated by the development of "synthetic" CDOs. Again, these synthetics were mirror images of "real" CDOs, thereby allowing an investor to play "fantasy" securitization. That is, the purchaser of a synthetic CDO does not "own" any of the underlying mortgage or securitized instruments, but is simply placing a "bet" on the financial value of a the CDO that is being mimicked.

Because both "naked" CDS and "synthetic" CDOs were nothing more than "bets" on the viability of the subprime market, it was important for this financial market to rely upon the fact that the CFMA expressly preempted state gaming laws.[6]

It is now common knowledge that: (1) issuers of CDS did not (and will not) have adequate capital to pay off guarantees as housing prices plummet, thereby defying the supposed "risk free" nature of issuing huge guarantees for the small premiums that were paid; (2) because CDS are private bilateral arrangements for which there is no meaningful "reporting" to Federal regulators, the triggering of the obligations there under often come as a "surprise" to both the financial community and government regulators; (3) as the housing market worsens, new CDS obligations are triggered, creating heightened uncertainty about the viability of financial institutions who have or may have issued these instruments, thereby leading to the tightening of credit; (4) the issuance of "naked" CDS increases exponentially the obligations of the CDS underwriters; and (5) the securitization structure (*i.e.,* asset backed securities, CDOs and CDS) is present not only in the subprime mortgage market, but in the prime mortgage market, as well as in commercial real estate, credit card debt, and auto and student loans. As these latter parts of the economy falter, the toxicity of the underlying financial structure falls into a continuous destabilizing pattern.

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tion.'" O'Harrow and Denis, *Downgrades and Downfall,* WASHINGTON POST (December 31, 2008) A1.

[5] Goodman, *The Reckoning: Taking Hard New Look at a Greenspan Legacy* (October 9, 2008) A1; *http://mobile.newsweek.com/detail.jsp?key=39919&rc=camp2008&p=0&all=1.*

[6] Johnson & Hazen, Derivatives Regulation, § 4.04[11] at 975 (2004 ed.) referencing 7 U.S.C. § 16(e)(2).

As a result, for example, the Fed is now spending $200 billion to buy instruments outside of the residential mortgage market.[7]

Finally, while CDS and synthetic CDOs constitute the lit fuse that leads to the exploding financial destabilization we are experiencing today, the remainder of the over-the-counter derivatives market has historically led to other destabilizing events in the economy, including the recent energy and food commodity bubble (energy and agriculture swaps), the failure of Long Term Capital Management in 1998 (currency and equity swaps), and the Bankers Trust scandal and the Orange Country bankruptcy of 1994 (interest rate swaps).

Because "swaps" are risk shifting instruments or, in their most useful sense, hedges against financial risk, they were almost certainly subject to the Commodity Exchange Act prior to the passage of the CFMA in 2000. The Commodity Future Trading Commission ("CFTC") in 1993 exempted swaps from that CEA's exchange trading requirement if their material economic terms were individually negotiated and if they were not traded on a computerized exchange.[8] However, the 1993 exemption did not satisfy the financial services sector and, by 1998, the market grew to over $28 trillion in notional value without utter disregard for the exchange trading requirements within the CEA.

As a result in May 1998, the CFTC, under the leadership of then Chair Brooksley Born, issued a "concept release" inviting public comment on how that multi-trillion dollar industry might most effectively be covered by the CEA on a "prospective" basis.[9] While that effort was blocked by the Executive Branch and Congress (including the passage of the CFMA in 2000), the CFTC concept release spelled out a menu of regulatory tools that have historically been applied to financial instruments, *e.g.,* equities, bonds, and traditional futures contracts that have the financial force to destabilize the economy systemically.

The classic *indicia* of regulation of financial instruments that have potential systemic adverse impacts on the economy include:

1. *Transparency.* These kinds of financial instruments are reported to, and, even often, registered with, a Federal oversight agency prior to execution. Transparency also requires that all transactions and holding be accounted for on audited financial statements. The present meltdown has been characterized by the use of off balance sheet investment vehicles, *e.g.,* structured investment vehicles ("SIVs") to house those instruments with potential systemic risk hidden from public view.

2. *Record Keeping.* Counterparties should be required to keep records of these transactions for 5 years.

3. *Immediate Complete Documentation.* Since August 2005, the Fed has complained that financial instruments pertaining to credit derivatives have been poorly documented with back offices being very far behind the execution of credit derivatives by sales personnel.

4. *Capital Adequacy.* Federal regulators traditionally require that parties to regulated transactions have adequate capital reserves to ensure payment obligations.

5. *Disclosure.* Federal regulators traditionally require full and meaningful disclosure about the risks of entering into the regulated transaction.

6. *Anti-fraud authority and anti-manipulation.* The regulated markets are governed by statutes that bar fraud and manipulation. The CFMA provided only limited fraud protection for counterparties by the SEC. The inadequacy of that protection is evidenced by both SEC Chairman Cox and former SEC Chairman Levitt calling regulation of these markets a "regulatory blackhole."[10] Fraud protection without transparency to the Federal regulator is meaningless. Moreover, no manipulation protection was included within the CFMA with regard to swaps. Effectively, the CFMA authorized this massive multi-trillion dollar worldwide swaps market without any provisions for protecting against fraud or manipulation. Fraud and anti-manipulation protections included within the securities and regulated futures laws should be restored to these markets.

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[7] GAO Report, *supra* note 17, at 31; Press Release, Federal Reserve, Nov. 25, 2008, available at *http://www.federalreserve.gov/newsevents/press/monetary/20081125a.htm.*

[8] 17 C.R.F. Part 35 (1993).

[9] 63 *Fed. Reg.* 26114 (May 12, 1998).

[10] *See* Speech by SEC Chairman Christopher Cox: Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System (Oct. 8, 2008).

7. *Registration of Intermediaries.* "Brokers" of equity and regulated futures transactions are subject to registration requirements and prudential conduct. There is no such protection within the swaps market.

8. *Private Enforcement.* As is true in securities laws and laws applying to the regulated futures markets, private parties in the swaps markets should have access to Federal courts to enforce anti-fraud and anti-manipulation requirements, thereby not leaving enforcement entirely in the hands of overworked (and sometimes unsympathetic) Federal enforcement agencies.

9. *Mandatory Self Regulation.* As is true of the securities and traditional futures industries, swaps dealers should be required to establish a self regulatory framework, including market surveillance.

10. *Clearing.* Again, as is true of the regulated securities and regulated futures infrastructure, a strong clearing intermediary should clear all trades as further protection against a lack of creditworthiness of counterparties.

The adoption of the traditional regulatory protections for swaps with systemic risk characteristics would essentially return these markets to where they were as a matter of law prior to the passage of the CFMA in 2000. The general template would be that swaps would have to be traded on a regulated exchange (which provides each of the protections outlined above) unless the proponents of a risk shifting instrument bear the burden of demonstrating to a Federal regulator that the instrument cannot cause systemic risk and will not lead to fraudulent or manipulative practices if traded outside an exchange environment. It is for that reason, for example, that, in 1993, the CFTC exempted from exchange trading requirements privately negotiated contracts not traded in standardized format.

The Senate Chair of the committee of jurisdiction over swaps, Senator Harkin,[11] has argued that trading in these instruments should be moved back onto regulated exchanges and he even posed the possibility of an outright ban on "naked" CDS. In other words, he has called for reversing the CFMA in this regard and returning to the regulated exchange trading environment with direct Federal oversight and self regulatory protections that existed prior to the passage of the CFMA.

Three final points should be made.

Simple Clearing Is Not Enough. The financial services industry and the Bush Administration have argued that clearing facilities for CDS will provide adequate regulation. Clearing proposals have been advanced to the FED, the SEC, and the CFTC, where they are in various stages of approval. As I understand it, the clearing is wholly voluntary. Second, clearing without each of the other regulatory attributes outlined above, while helpful, does not provide a systemic risk firewall. Stocks and traditional futures trading have a complete regulatory infrastructure built around the clearing process. For example, we would never settle for clearing, and clearing alone, as a substitute for the regulatory and self regulatory structure that surrounds the equities market.

Moreover, clearing without other prudential safeguards just places an apparently sound financial institution as the guarantor of the counterparties. Five years ago, AIG might have convincingly advanced itself as such an institution. Similarly, a AAA entity that appears sound today may become unstable if the entire derivatives market is not adequately policed. In sum, the limited step of clearing by itself does not adequately protect against systemic risk.

State Insurance Regulation. As mentioned above, CDS has all of the attributes of insurance. As a result, the New York Insurance Superintendant and the Governor of New York in September 2008 required that its insurance registrants trading CDS to those wanting to indemnify their own real risks in the mortgage market be subject to state insurance law by January 1, 2009 with corresponding capital adequacy

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[11] Lynch, *Harkin Seeks to Force All Derivatives on Exchanges,* WALL STREET JOURNAL, November 20, 2008 at *http://online.wsj.com/article/SB122721812727545583.html.* See also Hunton & Williams LLP, *The Derivatives Trading Integrity Act—Beginning of the End for OTC Trading?,* December 2008, available at *http://www.hunton.com/files/tbl_s10News%5CFileUpload44%5C15843%5Cderivatives_trading_integrity_act.pdf* ("Senate Agriculture Committee Chairman Tom Harkin (D-Iowa) introduced the Derivatives Trading Integrity Act of 2008 ('the bill'), hoping to end 'casino capitalism' in the market for over-the-counter (OTC) derivatives. The bill amends the Commodity Exchange Act (CEA) to require that all contracts with future delivery trade on regulated exchanges similar to how commodity futures currently trade . . . The bill reverses [the CFMA], forcing swap transactions to be conducted on designated or registered clearing houses or derivatives clearing organizations.").

requirements.[12] In this vein, it is interesting to note that AIG, a New York insurance regulatee, had $20 billion in reserve for each of its regulated insurance subsidiaries at the time it was rescued by the U.S. on September 17, 2008, because of CDS trading in an unregulated portion of the company. That fact seems to be unanswerable vindication of the efficacy of state insurance regulation, which is even now *not* preempted by the CFMA. In November 2008, New York temporarily suspended the CDS mandate it had issued in September on the theory that the prospects for Federal regulation had improved.[13] On January 24, 2009, the National Conference of Insurance Legislators is holding a hearing in New York City to discuss whether CDS should be subject to state regulation. My view is that state efforts in this should be encouraged as a further safeguard against systemic risk, especially insofar as the CFMA itself did not preempt state insurance laws. The CFMA limited its preemptive effect to state gaming and bucket shop laws.

As some commentators have also made clear, the New York Insurance Superintendant's proposed extension to of New York insurance law relating to those seeking to indemnify actual risks from the actual holding of CDOs is too limited. "Naked" CDS, or the guarantees to counterparties who hold *no* CDO risk and who just want to bet against mortgage commitments being fulfilled, are the kind of insurance that led to the creation of state insurance laws.[14] Under state insurance laws, you cannot insure against someone else's risk. Insurance of that kind creates so-called "moral hazard," or the creation of perverse and nonproductive incentives to take actions that will lead to the triggering of the insurance guarantee. For example, the holder of a "naked" CDS might want to interfere with mortgage "work outs" to avoid defaults on loans, thereby insuring that the "guarantee" against loan default within the naked CDS will be triggered. Accordingly, if states are to regulate here, they should bar "naked" CDS as the very kind of unlawful insurance that caused regulation in this area.

Finally, there is a strong "regulatory reform" movement to preempt some or all of state insurance law in favor of a Federal insurance regulator.[15] If the states "stand down" on the CDS market, *i.e.,* consciously decide not to regulate products that have all the elements of insurance, in favor of exclusive Federal regulation, that will be the first exhibit used by those advocating Federal regulation as to the purported inadequacy of state regulation. CDS represent class insurance products.[16]

Structural Regulation Alone. A further school of thought, most clearly evidenced by the President's Working Group on Financial Markets "regulatory reform" proposal of March 2008, is that the present regulatory failures have been caused by structural inadequacies, *e.g.,* too many regulators looking at huge institutions carrying out in a single structure a host of financial activities.[17] The March 2008 proposal was intended to mimic the U.K.'s then extant unified regulatory structure that was premised on "principles" rather than "rules." For example, the March 2008 proposal would merge the CFTC into the SEC, but have the SEC use the CFTC's "principles" based regulation. Moreover, the March 2008 proposal would hand over to the

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[12] New York State Insurance Dept., Recognizing Progress By Federal Government In Developing Oversight Framework For Credit Default Swaps, *New York Will Stay Plan To Regulate Some Credit Default Swaps,* press release, November 20, 2008 ("Dinallo announced that New York had determined that some credit default swaps were subject to regulation under state insurance law and that the New York State Insurance Department would begin to regulate them on January 1, 2009.").

[13] New York State Insurance Dept., Recognizing Progress By Federal Government In Developing Oversight Framework For Credit Default Swaps, *New York Will Stay Plan To Regulate Some Credit Default Swaps,* press release, November 20, 2008 (Superintendent Dinallo stating "I am pleased to see that our strong stand has encouraged the industry and the Federal Government to begin developing comprehensive solutions. Accordingly, we will delay indefinitely regulating part of the market.").

[14] Kimbal-Stanley, Arthur, *Dissecting A Strange Financial Creature,* THE PROVIDENCE JOURNAL, April 7, 2008 ("Insurance contracts used to protect against the loss of property owned by the person buying the policy helped the buyer eliminate the consequences of calamity. Insurance contracts used to bet on whether or not calamity would befall someone else's property not only let the buyer place a bet, it gave the buyer incentive to make that calamity occur, to destroy the insured property he did not own, to sink the other guy's ship, in order to collect on an insurance contract. In 1746, Parliament passed the Marine Insurance Act, requiring anyone seeking to collect on an insurance contract to have an interest in the continued existence of the insured property. Thus was born the insured-interest doctrine . . . The doctrines have been part of insurance law in both England and the United States (which in 1746 were colonies under English common law) ever since.").

[15] INSURANCE JOURNAL, *AIG Crisis Restarts Debate Over State vs. Federal Insurance Regulation,* September 17 2008, available at *http://www.insurancejournal.com/news/national/2008/09/17/93798.htm?print=1.*

[16] [No citation in submitted testimony.]

[17] *http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil__03122008.pdf.*

Fed considerable consolidated "rescue" powers. It may very well be that there needs to be a restructuring of the Federal regulatory system. However, the adverse lesson emanating from the creation of the Department of Homeland Security should be an object lesson in the dangers of governmental reorganization in a time of crisis. More importantly, it is not enough to improve Federal "rescue" capabilities. There are neither principles nor rules that govern the OTC derivatives market. It is a "blackhole." Even the U.K. is "reforming" its regulatory structure, recognizing that it was inadequate to the task in the present meltdown.

The CHAIRMAN. Thank you very much, Mr. Greenberger.

Mr. Gooch, welcome to the Committee.

STATEMENT OF MICHAEL A. GOOCH, CHAIRMAN OF THE BOARD AND CEO, GFI GROUP INC., NEW YORK, NY

Mr. GOOCH. Thank you.

I am Michael Gooch, Chairman and CEO of GFI Group Inc. Thank you, Chairman Peterson and Ranking Member Lucas, for inviting us here to testify today.

I began my career in financial brokerage in London in 1978, emigrated to the U.S. in 1979, and eventually became a naturalized U.S. citizen. I founded GFI Group in 1987 with $300,000 of capital. The firm is now one of five major global inter-dealer brokers, or IDBs, with approximately 1,700 employees on six continents and with $500 million in shareholder equity.

GFI Group is a U.S. public company listed on NASDAQ under the symbol GFIG. GFI Group and other inter-dealer brokers operate neutral marketplaces in a broad spectrum of credit, financial, equity, and commodity markets, both in cash instruments and derivatives. We are transaction agents to the markets we serve and do not trade for our own accounts. GFI is also a leading provider of electronic trading platforms to many global exchanges and competing IDBs.

GFI has been ranked as the number one broker of credit derivatives since the market began over 11 years ago, which provides us with far more experience with the product than any exchange. The leading IDBs offer sophisticated electronic trading technology that has been widely adopted in Europe and Asia. These European markets have functioned well in the wake of the credit crisis.

The electronic ATS trading environment for inter-dealer OTC–CDS that is operating successfully in Europe and Asia could be replicated in the U.S. immediately. Most, if not all, of GFI's individual brokers of credit derivatives in the U.S. are licensed, registered representatives, regulated by FINRA.

GFI supports this Committee's initiatives for greater transparency, central counterparty clearing, and effective regulatory oversight. However, the matter of central counterparty clearing is not a simple one. Any clearing mechanism is only as good as its members in the event that its initial clearing funds are exhausted. It is my opinion, and I believe it is shared by many in the financial community, that in the event major global investment banks had failed last September, then the clearinghouses of the various futures exchanges would have failed, too.

Sixty percent of the inter-bank volume in credit derivatives is transacted outside of the United States. To successfully achieve OTC clearing, large inter-bank dealer and global cooperation will be required. Notwithstanding the complexities of central clearing a global OTC credit derivatives market, it is my view that the listed exchanges can play an important role in introducing simple vanilla futures contracts on the most liquid indexes and single names. Both cleared and uncleared OTC and listed futures can co-exist as they do in most other financial markets.

I would like to specifically address two sections of the proposed legislation: section 14 and section 16.

We support the extension of CFTC regulation to the market for carbon offset credits and emissions allowances under section 14 of the bill. As a major broker of European emissions credits, we are very familiar with the importance of an orderly, efficient, and well-regulated marketplace. Therefore, we do not see a reason why the proposed legislation requires all trades to be done on a designated contract market and not also allowed on a CFTC-regulated DTEF. We believe that the limitation of transactions to DCMs needlessly stifles competition, leading to greater costs that are ultimately passed along to the consumer.

With regard to section 16, we are very concerned that the elimination of naked interest will kill the CDS market and significantly inhibit the liquidity of credit markets, including the market for corporate bonds and bank loans. Just as third-party liquidity providers and risk takers are willing to buy and sell futures and options in agricultural products, providing much-needed liquidity for businesses in agriculture to hedge and offset risk, so do such risk takers enhance liquidity in credit markets. There is plenty of capital on the sidelines today willing to take risk in credit without becoming direct lenders. This source of credit will not be available if the buying of credit derivatives is limited to those with a direct interest in the underlying instruments. That is because risk takers need to take risk on both sides of the market in order for there to be a liquid market.

New issuance of corporate debt cannot happen without a liquid, functioning bond market; and since credit derivatives are often more liquid than the market for the underlying bonds, it is clear that a functioning credit derivatives market is paramount for the unfreezing of credit markets. Killing the CDS market will contribute to an extended period of tight lending markets, where credit will only be available to the most secure borrowers, which will extend and deepen the current recession we are experiencing.

Thank you for this opportunity to address you today. I will be happy to answer any questions you may have.

[The prepared statement of Mr. Gooch follows:]

PREPARED STATEMENT OF MICHAEL A. GOOCH, CHAIRMAN OF THE BOARD AND CEO, GFI GROUP, INC., NEW YORK, NY

I am Michael Gooch, Chairman and CEO of GFI Group, Inc. Thank you Chairman Peterson and Ranking Member Lucas for inviting us to testify today.

About GFI Group: I began my career in financial brokerage in London in 1978, emigrated to the U.S. in 1979 and became a naturalized U.S. citizen. I founded GFI Group in 1987 with $300,000 of capital. The firm is now one of five major global "inter-dealer brokers" with approximately 1,700 employees on six continents and with 500 million dollars in shareholder equity. GFI Group is a U.S. public company listed on the NASDAQ under the symbol "GFIG".

GFI Group and the other inter-dealer brokers operate neutral market places in a broad spectrum of credit, financial, equity and commodity markets both in cash instruments and derivatives. GFI group has a strong presence in many over-the-counter (or "OTC") and listed derivative markets and has a reputation as being the leader globally in Credit Derivatives. We function as an intermediary on behalf of our brokerage clients by matching their trading needs with counterparties having reciprocal interests. We are transaction agents to the markets we serve and do not trade for our own account.

We offer our clients a hybrid brokerage approach, combining a range of telephonic and electronic trade execution services, depending on the needs of the individual markets. We complement our hybrid brokerage capabilities with decision-support service, such as value-added data and analytics products and post-transaction services including straight-through processing (or "STP") and transaction confirmations. We earn revenues for our brokerage services and charge fees for certain of our data and analytics products. We are also a leading provider of electronic trading software through our Trayport subsidiary, which licenses critical transaction technology in numerous product markets from energy to equities that is used by institutional market participants, such as futures exchanges and competing IDBs.

GFI is a global leader in numerous OTC derivatives markets. We have ranked as the number one broker for credit derivative since the market began over 11 years ago. In that time, GFI Group has brokered billions of dollars of credit derivative transactions that provides us with far more experience with the product than any exchange. In 2008, GFI was ranked as both the Number One Credit Derivative Broker and the Number One Commodity Broker.

About Inter-Dealer Brokerage:

I would like to take a moment to describe the market role played by inter-dealer brokers such as GFI. Inter-dealer Brokers (or "IDBS" as they are known) are an established part of the global, financial landscape. GFI and its competitors, aggregate liquidity and facilitate transactions in both OTC and exchange transactions between major financial and non-financial institutions around the world. IDBs cross transactions over-the-counter in listed futures in equities, energy and financial markets and post them to recognized exchanges within stringent regulator-mandated reporting time frames. The leading IDBs offer sophisticated electronic trading technology that has been widely adopted in Europe and Asia. These European markets have functioned well in the wake of the credit crisis.

In the credit derivatives market, for example, millions of electronic messages are recorded and processed by IDBs in real time every business day. With the most sophisticated IDBs that handle the bulk of the inter-dealer business in Europe, Asia and the U.S., the technology is connected via API to the Depository Trust Clearing Corporation (DTCC) the main central warehouse for CDS trades with Straight through Processing (STP) to all the major credit derivatives dealers. The electronic ATS trading environment for inter-dealer OTC–CDS that is operating successfully in Europe and Asia could be replicated in the U.S. immediately. At least four global regulated inter-dealer brokers have the ATS technology in place to achieve this now.

Most, if not all, of GFI's individual brokers of credit derivatives in the U.S. are licensed, registered representatives regulated by the Financial Industry Regulatory Authority (FINRA). Such IDBs with FINRA registered representatives keep electronic copies of all communications supporting each credit derivatives transaction they cross and the bids and offers leading up to those trades. Trading data, in some cases, goes back as far as 1996.

About the Proposed Legislation:

As a major aggregator of liquidity in OTC derivatives, GFI supports this Committee's initiatives for greater transparency, central counterparty clearing and effective regulatory oversight. We believe that enhancing transparency and eliminating counterparty risk will be a major improvement in the CDS market structure that will ensure its role as a credit transfer tool for investors.

We commend the Committee for its efforts to achieve these goals. We also support its efforts to provide the CFTC with greater regulatory oversight. We have a deep appreciation for the work of the CFTC. Our experience is that they are dedicated, competent, and hard working and have done an excellent job.

Nevertheless, the matter of central counterparty clearing is not a simple one. A central clearing mechanism requires a degree of standardization and price transparency not available for all instruments and all credits. Any clearing mechanism is only as good as its members in the event its initial clearing funds are exhausted. It is my opinion and I believe it is shared by many in the financial community that in the event certain major, global investment banks had failed last September, then the clearing houses of the various futures exchanges would have failed too. The large banks and prime brokers represent the bulk of the open interest on the various futures exchanges and the gapping of markets that would have occurred overnight in such an outcome would have led to a call on the capital of the very firms that may have failed. To have illiquid credits in such clearing mechanisms would only have exacerbated the problem. Since the large banks and prime brokers represent the bulk of the clearing capital at risk, it makes sense that a clearing solution provided by those banks with a high degree of transparency on pricing and mark to market makes the most sense.

We believe that the credit derivatives market could certainly benefit from a central counterparty. It would be a mistake, however, to presuppose that the entire market for credit derivatives operates only in the U.S. and that a single vertical clearing and execution venue can be designated for the entire global market. Sixty (60%) percent of the inter-bank volume in credit derivatives is transacted outside of the United States. Central counterparty clearing in CDS is a complex issue that is under-estimated by those that propose or believe it can be achieved almost overnight. To successfully achieve OTC clearing, large inter-bank dealer and global cooperation will be required.

Notwithstanding the complexities of centrally clearing a global OTC credit derivative market, it is my view that the listed exchanges can play an important role in introducing simple vanilla futures contracts on the most liquid indexes and single names. Both cleared and un-cleared OTC and listed futures can co-exist as they do in most other financial markets.

Issues Raised by the Proposed Legislation

I would like to specifically address two sections of the proposed legislation: section 14 and section 16.

We support the extension of CFTC regulation to the market for carbon offset credits and emission allowances under section 14 of the bill. As a major broker of European emissions credits, we are very familiar with the importance of an orderly, efficient and well regulated marketplace. Therefore, we do not see a reason why the proposed legislation requires all trades to be done on a Designated Contract Market (or "DCM") and not also on a CFTC-regulated "Derivatives Transaction Execution Facility" (or "DTEF"). We believe that the limitation of transactions to DCMs needlessly stifles competition leading to greater costs that are ultimately passed along to the consumer.

With regard to section 16, we are very concerned that limiting participation in the Credit Derivatives market to entities with a direct interest in the credit being protected, *i.e.,* elimination of naked interest, will kill the CDS market and significantly inhibit the liquidity of the credit markets, including the market for debt instruments such as corporate fixed income and bank loans. Just as third party liquidity providers and risk takers are willing to buy and sell futures and options in agricultural products providing much needed liquidity for businesses in agriculture to hedge and offset risk, so do such risk takers enhance liquidity in credit markets. There is plenty of capital on the side lines today willing to take risk in credit without becoming direct lenders. This source of credit will not be available if the buying of credit derivatives is limited to those with a direct interest in the underlying instruments. That is because risk takers need to take risk on both sides of the market in order for there to be a liquid market.

Without question, new issuance of corporate debt cannot happen without a liquid, functioning bond market and, since credit derivatives are often more liquid than the market for the underlying bonds, it is clear that a functioning credit derivatives market is paramount for the unfreezing of credit markets. Killing the CDS market will contribute to an extended period of tight lending markets where credit will only be available to the most secure borrowers. CDS has become so integral to the functioning of credit markets that killing it will extend and deepen the current recession we are experiencing.

In conclusion, let me just say that the global market for credit derivatives is not murky or unregulated as some would have us believe. Rather, it is highly liquid and, potentially, quite transparent. It is today functioning well and will play an important role in the unfreezing of the credit markets and the recovery of the global economy. That critical role could be jeopardized if we do not sort out the half-truths and misperceptions surrounding credit derivatives and their market structure. It is only then that the discussion of improving the credit derivatives market through central clearing and electronic trading can be put in proper context.

Thank you for this opportunity to address you today. I will be happy to answer any questions you may have.

The CHAIRMAN. Thank you very much, Mr. Gooch, for your testimony.

Mr. Cota, welcome to the Committee.

STATEMENT OF SEAN COTA, CO-OWNER AND PRESIDENT, COTA & COTA, INC.; TREASURER, PETROLEUM MARKETERS ASSOCIATION OF AMERICA, BELLOW FALLS, VT; ON BEHALF OF NEW ENGLAND FUEL INSTITUTE

Mr. COTA. Thank you, Honorable Chairman Peterson and Ranking Member Lucas, distinguished Members of the Committee. Thank you for the invitation to testify before you today. I appreciate the opportunity to provide some insight on your draft legislation.

First, I would like to thank Chairman Peterson and the Committee for their tireless efforts in bringing greater transparency and accountability to commodity markets. Without your dedication, this issue would never have gained the attention it deserves and needs.

I serve as an officer of the Petroleum Marketers Association of America. PMA is a national federation of 47 states and regional associations, representing over 8,000 independent fuel marketers. These marketers account for nearly half of the gasoline and nearly all of the distillate fuel consumed in the United States.

I am also here representing the New England Fuel Institute, which represents over 1,000 heating oil dealers in the Northeast.

Further, I am a third generation co-owner and operator of a home fuel delivery company in Vermont and New Hampshire. My business provides home heating fuel to 9,000 homes and businesses. I also market motor fuels and biofuels. Unlike larger energy companies, most retail fuel dealers are small, family-run businesses that personally deliver products to the doorstep of American homes and businesses.

We respectfully urge the Committee to impose aggregate position limits at the control entity level on noncommercial traders across all trading environments, including the over-the-counter markets that do not have any direct physical connection to the underlying commodity.

We have been voicing our concerns to Congress regarding dark markets for more than 3 years. Large-scale institutional investors speculating in the energy markets continue to act as the driving force behind energy prices. The rise in crude oil prices, which reached $150 a barrel for December delivery in July of last year, only to fall to a low of $33, was not the result of supply and demand. It was the direct result of large and excessively leveraged speculators, index traders, and hedge funds.

According to a *CBS News 60 Minutes* investigation last month, oil should not have skyrocketed to the levels seen last year. The piece highlighted how investment speculators, or "invesculators," looking to make a fast buck in a paper trade caused oil prices to rise faster and fall harder than ever could be explained by ordinary market forces alone. American consumers, small businesses, and the broader economy were forced into a roller coaster ride of greed and fear.

The retail petroleum industry is one of the most competitive industries, dominated by small, independent businesses. As gas prices go up, markets become even more competitive; and, at times, retailers sell gasoline below cost. In addition, because they must pay for their inventory before they sell it, credit lines were stretched to the max, creating a credit crisis with marketers' banks. The resulting liquidity problems caused serious financial hardship for many petroleum marketers and gas station owners. Many were forced to close shop.

This problem extends to the heating fuel industry. In the summer of 2008, Goldman Sachs, which trades commodities, predicted that crude oil would hit $200 per barrel, translating to $6 per gallon heating oil by winter. Heating oil dealers, who typically hedge fuel in warmer months, were experiencing the highest prices ever. Some consumers, scared by these statements made by Goldman Sachs and others, demanded fixed-price agreements with their dealers in an attempt to shelter their family from higher prices. Many dealers offered these contracts. They committed to purchase fuel they needed to supply these contracts during the winter months; and when the invesculators exited the market this fall, heating fuel dealers and their customers who had locked in were committed to a fuel at a much higher cost than it is currently worth.

Commodity markets were not designed as an investment class. They are set up for physical hedgers and to manage price risk by entering into futures contracts to hedge price for future delivery. *Bona fide* hedgers, like my company, rely on these markets to provide the consumer with quality product at a price that is reflective of market fundamentals. Traditional speculators are important and healthy in this role; invesculators are not.

We support the bill and urge Congress to move it quickly through the legislative process. Do not allow this important bill to be stalled by the financial service regulatory reform debate that is ongoing or by Wall Street's opposition.

We strongly support the following provisions in this bill: expanding transparency, record-keeping, and clearing requirements to the OTC trades; closing the foreign markets or the London loophole; closing the swaps trading loophole to distinguish between legitimate hedgers and pure speculation; and providing the CFTC with sufficient staff and resources to do its job.

We also urge you to make further adjustments to the bill by immediately mandating aggregate speculation limits in energy futures trades across all markets at the control level or the ownership level for contracts traded within the United States or by U.S. traders. Additionally, we urge you to mandate the aggregate position limits, regardless of any study that takes place required under section 9 of the bill.

We are encouraged by your desire to take a strong stand against excessive speculation and abusive trading practices that have artificially inflated energy and severely damaged our economy. Let's return these markets so that they are driven by supply and demand and not purely by the speculative whims and greed of Wall Street.

Thank you for this opportunity to testify.

[The prepared statement of Mr. Cota follows:]

PREPARED STATEMENT OF SEAN COTA, CO-OWNER AND PRESIDENT, COTA & COTA, INC.; TREASURER, PETROLEUM MARKETERS ASSOCIATION OF AMERICA, BELLOW FALLS, VT; ON BEHALF OF NEW ENGLAND FUEL INSTITUTE

Honorable Chairman Peterson, Ranking Member Lucas and distinguished Members of the Committee, thank you for the invitation to testify before you today. I appreciate the opportunity to provide some insight on draft legislation entitled the "Derivatives Markets Transparency and Accountability Act." I am also pleased to speak to the affect that opaque, inadequately regulated commodities markets and abusive trading practices have had on our nation's independent fuel marketers and home heating fuel providers.

First, I would like to thank Chairman Peterson and the Committee for their tireless efforts to bring greater transparency and accountability to commodity markets. Without your dedication, this issue would never have gained the attention it deserved.

I serve as Treasurer on the Petroleum Marketers Association of America's (PMAA) Executive Committee. PMAA is a national federation of 47 state and several regional trade associations representing over 8,000 independent fuel marketers. These marketers account for approximately half of the gasoline and nearly all of the distillate fuel consumed by motor vehicles and home heating equipment in the United States.

I am also here representing the New England Fuel Institute (NEFI), a 60 year old trade association representing well over 1,000 heating fuel dealers and related service companies within the Northeastern United States.

In addition, I speak before you today as co-Owner and President of Cota & Cota, Inc. of Bellows Falls, Vermont, a third generation family-owned and operated home heating fuel provider in southeastern Vermont and western New Hampshire. My business provides quality home heating fuel, including propane, heating oil and kerosene, to approximately 9,000 homes and businesses. I also market motor fuel, off-road diesel fuel, jet fuel and biofuels. Unlike larger energy companies, most retail fuel dealers are small, family-run businesses. Also unlike larger energy companies, we personally deliver product directly to the doorstep of American homes and businesses.

Before I begin, I would like to highlight the fact that PMAA and NEFI are hereby respectfully urging the Committee to *impose aggregate position limits at the control entity level on noncommercial traders and across all trading environments, including over-the-counter markets that do not have any physical connection to the underlying commodity.*

Our organizations have been voicing concern to Congress regarding the activities in "dark" commodity markets for more than 3 years now. It has become abundantly clear that large-scale, institutional investors speculating in the energy markets, were and continue to act as the driving force behind energy prices. The rise in crude oil prices, which reached $147 in July of last year only to fall dramatically to as low as $33 in December was not a result of supply and demand fundamentals—it was the direct result of excessively-leveraged speculators, index investors and hedge funds.

After 3 years of advocating for greater transparency and accountability in these markets, we have seen very little progress to this end. I would like to thank the Members of this Committee for passing the "Close the Enron Loophole Act" which was enacted as part of last year's farm bill. It was an important first step. However, as addressed by this Committee last year in H.R. 6604, this is a serious problem that needs a more aggressive legislative response, especially in light of the 2008 unprecedented run-up in commodity prices. The solution requires an unwavering commitment to vigorous oversight and enforcement by the new President and the Commodity Futures Trading Commission, which we believe to have been lacking in recent years.

According to a January 11, 2009 *60 Minutes* investigation titled, "Did Speculation Fuel Oil Price Swings?" several experts agreed that oil should not have skyrocketed to previously mentioned record levels last year, only to see prices dramatically collapse few months later. The piece highlighted how investors were looking not to actually buy oil futures, but to make a fast buck in a "paper trade." This practice caused oil prices to rise faster and fall harder than could ever be explained by ordinary market forces alone. American consumers, small businesses and the broader economy were forced onto a roller coaster ride of greed, fear and uncertainty. However, the greatest victim of the 2008 energy crisis was consumer confidence in these markets' ability to determine a fair and predictable price for energy.

In 2007 and most of 2008, gasoline and heating oil retailers saw profit margins from fuel sales fall to their lowest point in decades as oil prices surged. The retail motor fuels industry is one of the most competitive industries in the marketplace, which is dominated by small, independent businesses. Retail station owners offer the lowest price for motor fuels to remain competitive, so that they generate enough customer traffic inside the store where station owners can make a modest profit by offering drink and snack items. As gas prices go up, the market becomes even more competitive and at times retailers are selling gas at a loss. In addition, because petroleum marketers and station owners must pay for the inventory they sell, their lines of credit were approaching their limit due to the high costs of gasoline, heating oil and diesel. This created a credit crisis with marketers' banks, which created liquidity problems and caused serious financial hardship for many petroleum marketers and station owners—some even were forced to close up shop.

In the summer of 2008, Goldman Sachs, a firm that trades in the crude oil market, predicted that crude oil would hit $200 per barrel (translating to $6 per gallon heating oil) by winter. Heating oil dealers, who typically purchase fuel in the summer months when seasonal product costs are typically at their lowest, were experiencing higher prices than ever before. Some customers, scared by statements made by Goldman Sachs and others, began demanding a fixed-price agreement with their dealer in an attempt to shelter their family budgets from higher prices.

Many dealers offered such contracts to meet this demand, driving many of them to purchase the fuel needed to supply these contracts up front during the summer months; for fear that prices would only head higher. When institutional investors exited the market in the fall, heating fuel dealers and their customers who had "locked in" to a price contract were put in a very bad spot, committed to fuel at a much higher cost than its current worth. Many of these consumers are elderly Americans and struggling families trying to make ends meet in a slumping economy riddled with high unemployment rates and evaporating savings and retirement accounts.

Ignoring or unaware of the potential consequences of their actions, investment-only speculators were concerned only about turning a profit. They were completely disconnected from the commercial marketplace and the struggling consumers that fuel retailers like me serve personally every day. Commodity markets were not designed as an investment class—they were set up for physical hedgers to manage price risk by entering into a futures contract in order to lock in a price for future delivery. These "Investulators," funds who believe commodities are an asset class, are really unwitting speculators, and are so large and lack any commodity market fundamental knowledge; they have dramatically distorted the markets we rely on. The abuse of this original intent must end now.

We rely on these markets to provide the consumer with a quality product at a price reflective of market fundamentals. Traditional speculators serve an important and healthy role by providing needed liquidity in the commodities market for this to be accomplished. However, institutional investors have wreaked havoc on the price discovery mechanism that commodity futures markets provide to *bona fide* physical hedgers, including heating fuel dealers. Congress should act quickly to restore the transparency and oversight needed for secure and stable commodities markets and help restore the confidence in these markets that physical hedgers and consumer once had.

Therefore, PMAA and NEFI urge Congress to pass the "Derivatives Markets Transparency and Accountability Act" and enable the critical changes to the Commodity Exchange Act (CEA) needed for fully regulated futures markets. We further urge Congress to expedite commodity markets reform legislation through the legislative process and not allow the bill to be stalled by the financial services regulatory overhaul debate.

PMAA and NEFI strongly support most provisions in the "Derivatives Markets Transparency and Accountability Act," including:

- Distinguishing between legitimate hedgers in the business of actually delivering the fuel to consumers, and those who are in the market for purely speculative purposes;
- Closing the "London Loophole" by requiring foreign exchanges with energy contracts for delivery in the U.S. and/or that allow U.S. access to their platforms to be subject to comparable U.S. rules and regulations;
- Closing the "Swaps Loophole" which allows so-called "index speculators" (that now amount to ⅓ of the market) an exemption on position limits which enable them to control unlimited amounts of energy commodities; and
- Increasing staff at the CFTC with an additional 200 employees and other resources.

While we applaud the Committee for its diligent work on this legislation, we urge you to make the necessary adjustments to the "Derivatives Markets Transparency and Accountability Act of 2009" by **mandating aggregate speculative position limits on energy futures across all contract markets at the control or ownership level for contracts traded within the U.S. or by U.S. traders.** This important measure will help return the market to the physical market participants it was intended to serve. Aggregate position limits will also prevent a trader from going into one commodity exchange and trading the maximum amount of crude oil allowed and then going into another exchange to trade another large amount of futures positions, thereby circumventing anti-manipulation measures in order to take a massive and controlling position in one commodity. Additionally, PMAA and NEFI urge you to either strike Section 9—Review of Over-the-Counter Markets, which requires the CFTC to study and report on the effects of potential position limits in OTC trading and aggregate limits across the OTC market, designated contract markets, and derivative transaction execution facilities. Or to include section 9 but still mandate aggregate OTC position limits immediately before any study takes place.

We and our customers need our public officials in the new Congress, including those on this Committee, in the new Administration and the CFTC, to take a stand against excessive speculation and abusive trading practices that artificially inflate energy prices. We strongly support the free exchange of commodity futures on open, well regulated and transparent exchanges that are subject to the rule of laws and accountability. Reliable futures markets are crucial to the entire petroleum industry and the American economy. Let's make sure that these markets are competitively driven by supply and demand and not the speculative whims and greed of Wall Street.

Thank you again for allowing me the opportunity to testify before you today.

The CHAIRMAN. Thank you, Mr. Cota.

Welcome. I appreciate your testimony. Mr. Duffy, welcome to the Committee.

STATEMENT OF HON. TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN, CME GROUP INC., CHICAGO, IL

Mr. DUFFY. Thank you; and let me echo my fellow panelists and thank you, Chairman Peterson and Ranking Member Lucas, for the opportunity to present our views.

The CME Group Exchanges are neutral marketplaces. Our Congressionally mandated role is to operate markets that foster price discovery and hedging in a transparent, efficient, self-regulated environment overseen by the CFTC. We provide producers and processors with necessary information to make important economic decisions and serve their global risk management needs. We offer a comprehensive selection of benchmark products in all major asset classes.

We are also joining market users to operate a green exchange. This exchange will provide trading and clearing services to serve cap and trade programs respecting emissions and allowances.

Additionally, we are joint venturers with Citadel to provide trading and clearing platforms for credit default swaps. Our risk analytics and financial safeguards have been thoroughly examined by the CFTC, the Federal Reserve, and the SEC. So we appreciate the proposed clarification that will enhance our ability to provide clearing services for credit default swap contracts. We also appreciate that it will not infringe on the SEC's regulatory responsibilities and will permit competition in this very important market.

The draft bill is offered as an amendment to the Commodity Exchange Act to bring greater transparency and accountability to commodity markets. We support the bill's purpose to enhance the enforcement capabilities and structure of the CFTC, but it is essential that care be taken to avoid constraints on U.S. markets that would further weaken the already fragile U.S. economy, damage the competitiveness of U.S. markets, hurt U.S. consumers, produce less transparency, and deprive the Commission of vital information.

We understand that there may be some markets in which excessive speculation, as defined in the Commodity Exchange Act, may cause price distortion.

All agricultural and natural resource futures and options contracts are subject to either Commission or exchange spot month speculative position limits. The CFTC and the exchanges enforce those limits. We do not agree that hard position limits play a constructive role, either with commodities that are not physically delivered or with commodities whose trading does not affect any physically delivered market. We do not agree that the CFTC should be the front-line regulator setting hard limits.

We also disagree with the creation of advisory committees for setting hard limits in agriculture and energy products. The proposed committees are dominated by long and short hedgers who are not constrained by any standards, and who do not operate subject to a defined process. We are concerned that these committees may excessively influence the setting of limits. Also, they may adversely affect the ability of our markets to efficiently perform their price discovery function.

In addition, we believe the bill's direction to the Commission is overly restrictive in defining a direct hedging transaction; and it is restrictive with respect to dealers, funds, and others who have assumed risks in the over-the-counter market which are consistent with their legitimate businesses.

We are strong proponents of the benefits of central counterparty clearing. It is an effective means to collect and provide timely information to regulators. It also greatly reduces systemic risk imposed on financial systems by unregulated bilateral OTC transactions.

We would benefit from section 13 of the draft bill, but we are not confident that it is workable. If the OTC dealers do not embrace clearing, they can easily transact in another jurisdiction. In that way, they could avoid the obligations imposed by the draft bill. This could cause significant damage to a valuable domestic industry.

We urge the Committee to shape its bill in recognition of the reality of markets that operate in a global economy. Trading systems are electronic, banking is international, and every important trader has easy access to markets that are not regulated by the CFTC and not constrained by this bill. We are concerned with prohibitions or costly impediments to legitimate business activities in the United States. We believe they will divert business to jurisdictions that adopt other regulatory measures to protect against future meltdowns.

We are eager to work with the Committee and the industry to help shape incentives that will encourage clearing and other provisions that support the goal of this bill. My written testimony highlights several technical issues in the draft. More importantly, it offers our pledge to work with the Committee and help assure that U.S. futures markets remain positive contributors to our economy.

Thank you, sir.

[The prepared statement of Mr. Duffy follows:]

PREPARED STATEMENT OF HON. TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN, CME GROUP INC., CHICAGO, IL

I am Terrence Duffy, Executive Chairman of Chicago Mercantile Exchange Group Inc. ("CME Group" or "CME"). Thank you Chairman Peterson and Ranking Member Lucas for this opportunity to present our views.

CME Group Exchanges

CME Group was formed by the 2007 merger of Chicago Mercantile Exchange Holdings Inc. and CBOT Holdings Inc. CME Group is now the parent of CME Inc., The Board of Trade of the City of Chicago Inc., NYMEX and COMEX (the "CME Group Exchanges"). The CME Group Exchanges are neutral market places. They serve the global risk management needs of our customers and producers and processors who rely on price discovery provided by our competitive markets to make important economic decisions. We do not profit from higher or lower commodity prices. Our Congressionally mandated role is to operate fair markets that foster price discovery and the hedging of economic risks in a transparent, efficient, self-regulated environment, overseen by the CFTC.

The CME Group Exchanges offer a comprehensive selection of benchmark products in all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, agricultural commodities, energy, and alternative investment products such as weather and real estate. We are in the process of joining with market users to operate a green exchange to provide trading and clearing services that will serve cap and trade programs respecting emissions and allowances.

We are joint venturers with Citadel to provide trading and clearing platforms for credit default swaps. Our risk analytics and financial safeguards have been thoroughly vetted by the CFTC, the Federal Reserve and the SEC. Our efforts to open our doors have been complicated by jurisdictional issues, but we are very close to a launch of the service.

We also offer order routing, execution and clearing services to other exchanges as well as clearing services for certain contracts traded off-exchange. CME Group is traded on NASDAQ under the symbol "CME."

Executive Summary

The draft bill that was recently circulated is purposed as an amendment "to the Commodity Exchange Act to bring greater transparency and accountability to commodity markets." We support that statement of the bill's purpose. We unequivocally support enhancing the enforcement capabilities and machinery of the CFTC, but it is essential that care be taken to avoid constraints on U.S. markets that will further weaken the already fragile U.S. economy; damage the competitiveness of U.S. markets; hurt U.S. consumers and produce less transparency and deprive the Commission of vital information.

We understand that there may be some markets in which "excessive speculation," as defined in the CEA, may cause price distortion; we set hard limits in those markets or enforce CFTC limits. We do not agree that hard position limits play a constructive role with respect to commodities that are not physically delivered and commodities whose trading does not affect any physical delivery market. We do not agree that the CFTC should be the front-line regulator setting hard limits. We disagree with the creation of "advisory" committees for setting hard limits in agriculture and energy products. The proposed committees are dominated by long and short hedgers, who are not constrained by any standards and who do not operate subject to a defined process. We are concerned that these committees will inordinately influence the setting of limits and will adversely affect the ability of our markets to efficiently perform their price discovery function. We believe that the bill's direction to the Commission to define a *bona fide* hedging transaction is overly restrictive both with respect to direct hedgers and its constraints on the ability of dealers, funds and others who have assumed risks in the over the counter market, which are consistent with their legitimate businesses.

We are strong proponents of the benefits of central counterparty clearing as an effective means to collect and provide timely information to prudential and supervisory regulators and to greatly reduce systemic risk imposed on the financial system by unregulated bilateral OTC transactions. We would be a major beneficiary of section 13 of the draft bill, but we are not confident that it is practicable. If the OTC dealers do not embrace clearing, they can easily transact in another jurisdiction, avoid the obligations imposed by the draft bill and cause significant damage to a valuable domestic industry. We urge the Committee to shape its bill in recognition of the reality of markets that operate in a global economy. Trading systems are electronic, banking is international, and every important trader has easy access to markets that are not regulated by the CFTC and not constrained by this bill. Prohibitions or costly impediments to legitimate business activities in the U.S. will simply divert business to jurisdictions that adopt rational measures to deal with the causes and protection against future financial meltdowns. We are eager to work with the Committee and the industry to shape incentives that will encourage clearing in appropriate cases and bring us quickly to the end position envisioned by the bill.

Finally, we appreciate the proposed clarification that will enhance our ability to provide clearing services for credit default swap contracts in a manner that does not infringe on the SEC's regulatory responsibilities and that will permit competition in this important market across regulatory regimes. We are concerned, however, that the bill will foreclose trading of CDSs in the U.S.

Drafting and Technical Issues

We welcome a dialogue with the Committee's staff to resolve our technical and philosophical concerns with the draft. For convenience, we describe our most serious concerns below.

Sec. 3. Speculative Limits and Transparency of Offshore Trading.

Subpart (a) directs the Commission to preclude direct access from the U.S.: "to the electronic trading and order matching system of the foreign board of trade with respect to an agreement, contract, or transaction that settles against any price (including the daily or final settlement price) of one or more contracts listed for trading on a registered entity," unless the foreign board of trade satisfies a broad set of conditions respecting position limits, information sharing, and the definition of *bona fide* hedging.

The draft bill is calibrated appropriately to focus only on a narrow range of contracts that might be traded on a foreign board of trade, although we wonder why it is restricted to financially settled contracts and does not include substantially identical physically settled contracts. We are, nonetheless, concerned that this effort may provoke retaliatory behavior from foreign governments or regulatory agencies that could severely impair our business.

Sec. 4. Detailed Reporting and Disaggregation of Market Data.

Section 4 amends the CEA to require that the Commission issue a "rule defining and classifying index traders and swap dealers (as those terms are defined by the Commission) for purposes of data reporting requirements and setting routine detailed reporting requirements for any positions of such entities . . . ." The draft requires the Commission to impose "routine detailed reporting requirements" on such traders. It is unclear that a higher level of routine reporting for such traders is necessary or appropriate; the Commission is empowered to issue special calls for information without demonstrating any cause. Section 4 also requires swap dealers and index traders to report all positions on foreign boards of trade, without regard to whether those positions implicate any U.S. regulatory interests. It is not clear that this was intended; it is not necessary and imposes an unnecessary burden on the CFTC.

Section 4 also includes a reporting provision that we do not understand. The Commission is required to publish: "data on speculative positions relative to *bona fide* physical hedgers in those markets to the extent such information is available." The Commission does not have information on hedgers who do not exceed speculative limits: in consequence this number is likely to be highly misleading.

Sec. 5. Transparency and Recordkeeping Authorities.

Subpart (a) extends the reporting requirements for CFTC registrants beyond trading on any board of trade in the United States or elsewhere to include OTC "trading of transactions and positions traded pursuant to subsection (d), (g), (h)(1), or (h)(3) of section 2, or any exemption issued by the Commission by rule, regulation or order." We agree that these transactions should not escape CFTC scrutiny but question whether subsection (a) is necessary in light of the special call provisions in subpart (b).

Sec. 6. Trading Limits To Prevent Excessive Speculation.

Section 6 requires the Commission to: "establish limits on the amount of positions, as appropriate, other than *bona fide* hedge positions, that may be held by any person . . ." The mandatory limits apply to all commodities traded on regulated markets, without regard to whether excess speculation has ever been an issue in the commodity or whether it is a foreseeable danger. The standard that the Commission must apply is:

"(B) to the maximum extent practicable, in its discretion—

(i) to diminish, eliminate, or prevent excessive speculation as described under this section;

(ii) to deter and prevent market manipulation, squeezes, and corners;

(iii) to ensure sufficient market liquidity for *bona fide* hedgers; and

(iv) to ensure that the price discovery function of the underlying market is not disrupted; and

(C) to the maximum extent practicable, in its discretion, take into account the total number of positions in fungible agreements, contracts, or transactions that a person can hold in other markets."

We are concerned that the bill imposes conflicting standards and offers no guidance to the Commission on how those conflicts are to be resolved other than that each is to be fulfilled to the maximum extent practicable. Position limits are a device to promote liquidation and orderly delivery in physical contracts. If position limits are not being used for those purposes they artificially impose restrictions on access to markets and are more likely to prevent prices from reaching a true equilibrium than to serve a positive purpose.

Moreover, position limits are not appropriate for all commodity contracts. Where the final price of the futures contract is determined by reference to an externally calculated index that is not impacted by the futures market, for example rainfall during a fixed period, position limits cannot be justified. Most financial futures traded on CME Group are not settled by delivery of an underlying commodity and therefore are not readily susceptible to market manipulation. In such a case, accountability levels are more appropriate than position limits.

Mandating position limits in non-spot month physical delivery contracts is unnecessary because those contracts do not have a close, direct impact on the price discovery function for the cash market of the underlying commodity. Accountability levels are sufficient to deter and prevent market manipulation in non-spot months.

CME Group has numerous surveillance tools, which are used routinely to ensure fair and orderly trading on our markets. Monitoring the positions of large traders in our market is a critical component of our market surveillance program. Large trader data is reviewed daily to monitor reportable positions in the market. On a daily basis, we collect the identities of all participants who maintain open positions that exceed set reporting levels as of the close of business the prior day. Generally, we identify in excess of 85% of all open positions through this process. This data, among other things, are used to identify position concentrations requiring further review and focus by Exchange staff. Any questionable market activity results in an inquiry or formal investigation.

Section 6 also requires that the Commission establish advisory committees with respect to agriculture based futures and energy based futures to advise the Commission on speculative position limits. These advisory committees are, by law, dominated by enterprises that have a direct interest in the markets on which they are advising. In addition to this inherent conflict, the bill offers no standard to direct the deliberations of these advisory committees. Instead, it puts 19 or 20 people, with diverging financial interests, in a room and tells them to make a decision. We strongly oppose this process, which empowers market participants whose objectives differ materially from the CEA's purpose in establishing position limits.

Regulated futures markets and the CFTC have the means and the will to limit speculation that might distort prices or distort the movement of commodities in interstate commerce. Former CFTC Acting Chairman Lukken's testimony before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce United States House of Representatives (December 12, 2007) offers a clear description of these powers and how they are used:

> All agricultural and natural resource futures and options contracts are subject to either Commission or exchange spot month speculative position limits—and many financial futures and options are as well. With respect to such exchange spot month speculative position limits, the Commission's guidance specifies that DCMs should adopt a spot month limit of no more than ¼ of the estimated spot month deliverable supply, calculated separately for each contract month. For cash settled contracts, the spot month limit should be no greater than necessary to minimize the potential for manipulation or distortion of the contract's or underlying commodity's price. For the primary agricultural contracts (corn, wheat, oats, soybeans, soybean meal, and soybean oil), speculative limits are estab-

lished in the Commodity Exchange Act and changes must be approved via a petition and public rulemaking process.

http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opalukken-32.pdf.

Subsection (2) directs the Commission to define a *bona fide* hedge, which permits traders to exceed the hard speculative limits. Proposed subpart (A) pertains to hedgers acting for their own accounts. Subpart (B) governs swap dealers and others who are hedging risks assumed in the OTC market. We believe that subpart (A) has unintended and highly detrimental consequences respecting the ability of regulated futures exchanges to provide hedging opportunities for important business enterprises. The bill provides that a futures position does not qualify as a *bona fide* hedge unless it: "(A)(i) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel . . . ." This interpretation is compelled by the linking of clauses (i), (ii) and (iii) by the conjunctive "and," which requires that all three conditions be satisfied.[1] As a result, the provisions in (ii) and (iii), which currently operate as independent grounds for a hedge exemption, are nullified. This works perfectly for a grain elevator or farmer who shorts his inventory or expected crop. Futures markets, however, are also used for more sophisticated hedging.

Obviously, this limitation precludes electric utilities from hedging capacity risks associated with weather events by use of degree day unit futures contracts. That hedge involves no substitute for a transaction in a physical marketing channel. Insurance companies may not hedge hurricane or other weather risks. Enterprises that consume a commodity that is not used in a "physical marketing channel" such as airlines that use fuel, generating facilities that use gas and produce electricity, freight companies whose loads depend on geographic pricing differentials and hundreds of other important examples that readily present themselves, will not be entitled to a hedge exemption from mandatory speculative limits. Even if "or" were substituted, a significant number of clearly legitimate hedging transactions are precluded.

Subpart (B) offers swap dealers a very narrow window within which to qualify for a hedge exemption. The position being hedged must reduce: "risks attendant to a position resulting from a transaction that—. . . was executed opposite a counterparty for which the transaction would qualify as a *bona fide* hedging transaction . . . ." On a practical basis, swap dealers use the futures market to reduce their overall risk; we do not believe that particular futures positions can be linked to identified OTC transactions. Thus, the utility of futures markets as a risk transfer venue will be seriously impaired. We are happy to work with the staff to devise language that will eliminate the use of OTC intermediaries as a mask for trading that would otherwise violate position limits.

We believe that the bill's direction to the Commission to define a *bona fide* hedging transaction set out in section 6(2) is overly restrictive with respect to its constraints on the ability of dealers, funds and others who have assumed risks in the over-the-counter market, which are consistent with their legitimate businesses, to transfer the net risk of their OTC positions to the futures markets. CME Group is concerned that this limitation on hedge exemptions for swap dealers will limit the ability of commercial enterprises to execute strategies in the OTC market to meet their hedging needs. For example, commercial participants often need customized OTC deals that can reflect their basis risk for particular shipments or deliveries. In addition, not all commercial participants have the skill set necessary to participate directly in active futures markets trading. Swap dealers assume that risk and lay it off in the futures market.

This restriction contravenes the otherwise clear intent of the draft bill to limit systemic risk by driving OTC generated risk into a central counterparty clearing

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[1] "(2) For the purposes of contracts of sale for future delivery and options on such contracts or commodities, the Commission shall define what constitutes a *bona fide* hedging transaction or position as a transaction or position that—

"(A)(i) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel;

"(ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and

"(iii) arises from the potential change in the value of—

"(I) assets that a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising;

"(II) liabilities that a person owns or anticipates incurring; or

"(III) services that a person provides, purchases, or anticipates providing or purchasing;"

context. The consequences of this constraint are magnified by the simultaneous imposition of hard position limits on financial futures that are settled by reference to prices that are not susceptible to manipulation, such as Eurodollars or currencies.

Sec. 8. Review of Prior Actions.

Section 8 of the proposed bill imposes a burden on the Commission that is not justified and that will divert it from the important responsibilities assigned to it in section 7. It requires the Commission to:

> "review, as appropriate, all regulations, rules, exemptions, exclusions, guidance, no action letters, orders, other actions taken by or on behalf of the Commission, and any action taken pursuant to the Commodity Exchange Act by an exchange, self-regulatory organization, or any other registered entity, that are currently in effect, to ensure that such prior actions are in compliance with the provisions of this Act."

No guidance is offered as to what is appropriate, and we are unaware of any action that the Commission has taken, including those with which we have disagreed, that could be found to be "not in compliance with the 'provisions of this Act.'" The review of the rules of the rules of registered entities and the NFA will be a massive undertaking, given the size and complexity of the rule books, interpretations and notices that govern the business of the registered entities and the NFA and the lack of direction. We are not aware of any significant dissatisfaction with the Commission's actions or the actions of the registered entities and the SRO's that would compel so wide-reaching a review.

Sec. 11. Over-The-Counter Authority.

Section 11 authorizes the Commission to impose position limits on transactions exempted or excluded from the CEA by "subsections (d), (g), (h)(1), and (h)(3) of section 2," if it first finds that such contracts are: "fungible (as defined by the Commission) with agreements, contracts, or transactions traded on or subject to the rules of any board of trade or electronic trading facility with respect to a significant price discovery contract . . . ." We are surprised by the use of the term "fungible," which is generally limited to contracts that may be offset. We assume that this power should apply when the contracts are close economic substitutes. Second, the reference to the defined term "board of trade" rather than the phrase "designated contract markets and derivatives transaction execution facilities" or "registered entity" (as is ordinarily used in the bill) is bound to be afforded some significance, which escapes us. While we are generally in agreement with the purposes of this section, we expect that representative of the participants in the OTC market are best positioned to discuss the impact of this provision and any other technical drafting issues.

Sec. 12. Expedited Process.

Section 12 grants the Commission authority to act in an expedited manner "to carry out this Act if, in its discretion, it deems it necessary to do so." The Commission currently has comprehensive authority to respond to an emergency. This provision eliminates the salutary requirement that there be an emergency before the Commission is empowered to act precipitously and we do not agree that it is either necessary or appropriate to grant such powers.

Sec. 13. Certain Exclusions and Exemptions Available Only for Certain Transactions Settled and Cleared Through Registered Derivatives Clearing Organizations.

Section 13 is intended to force certain transactions that were exempted from the exchange trading requirement and most other Commission regulations by 2(d)(1)(C), 2(d)(2)(D), 2(g)(4), 2(h)(1)(C), or 2(h)(3)(C) of the Act either onto a regulated trading platform or to be cleared by a CFTC Designated Clearing Organization or a comparable clearing house. While this section appears to favor our organization and advances our goals, we are concerned that it will fail to produce the desired result and negatively impact the U.S. derivatives industry. We discussed this point in the introductory portion of this testimony.

Sec. 14. Treatment of Emission Allowances and Offset Credits.

Section 14 authorizes the trading of: "any allowance authorized under law to emit a greenhouse gas, and any credit authorized under law toward the reduction in greenhouse gas emissions or an increase in carbon sequestration." The CEA was already sufficiently broadly worded to permit such contracts to be traded on futures exchanges subject to the Commission's exclusive jurisdiction. We are concerned that the specific description may, in the future, be read as a limitation on the authority to create futures contracts relating to the greening of America and we believe that the Committee needs to generalize the language to avoid that implication.

Sec. 16. Limitation on Eligibility To Purchase A Credit Default Swap.

Section 16, which makes it: "unlawful for any person to enter into a credit default swap unless the person would experience financial loss if an event that is the subject of the credit default swap occurs" is worded in a manner that prohibits the use of credit default swaps for any purpose. The language requires both the buyer and seller of credit protection to suffer a loss if the event were to occur and there was no credit default swap in place. Obviously, only the buyer of credit protection qualifies.

However, even if the language were corrected, we are opposed to this provision as an unwarranted restriction on functioning of free markets. This provision punishes the instrument and legitimate users of the instrument for the excesses of the management of AIG. The instrument was innocent as were the vast bulk of the users of the instrument and the markets in which the instruments were transacted. We do not purport to be the appropriate spokesperson for the industry, but we can assure you that all of our plans to clear CDSs will come to naught if this provision is adopted.

Credit default contracts serve an important economic purpose in an unfortunately imperfect manner. At the ideal level, credit default contracts permit investors to hedge specific risk that a particular enterprise will fail or that the rate of failure of a defined group of firms will exceed expectations. However, because credit default contracts are not insurance, investors who are not subject to any specific risk can assume default risk to enhance yield or buy protection against a default to speculate on the fate of a company or the economy generally. Credit default contracts are also an excellent device to short corporate bonds, which otherwise could not be shorted.

If such contracts are executed in a transparent environment, if the regulators responsible for controlling systemic risk can easily keep track of the obligations of the banks, brokers and other participants in the market and if a well regulated clearing house acts as the central counterparty for such contracts, we believe that they can serve an important role in our economy without imposing undue systemic risks.

Conclusion:

Futures markets perform two essential functions—they create a venue for price discovery and they permit low cost hedging of risk. Futures markets depend on short and long term speculators to make markets and provide liquidity for hedgers. Futures markets could not operate effectively without speculators and speculators will not use futures markets if artificial barriers or tolls impede their access. CFTC-regulated futures markets have demonstrated their importance to the economy, the nation's competitive strength and America's international financial leadership. We have the means and the power to protect our markets against speculative excesses and are committed to doing so.

The CHAIRMAN. Thank you, Mr. Duffy.

I thank all of the panel members for their excellent testimony. We again appreciate you being with us.

I don't want to pick on you, Mr. Duffy, but, because you were last, on December 8th of last year you stated in response to a direct question from me your support for mandatory clearing of all CDSs. Today, however, your testimony seems to back away from this position in your statement that if the OTC dealers do not embrace clearing, they could easily transact in another jurisdiction. You didn't cite this concern previously; is this a new concern?

Mr. DUFFY. Mr. Chairman, with all due respect, on supporting mandatory clearing, you are right, sir, I did support it. But, at the same time, I did say that there are some products that are traded today that are not suitable for clearing because of the nature of the risk that they may present to the clearing operation.

So, yes, we do support the mandatory clearing. I did say that at your Committee hearing. But we are also realistic that there are some products that would not benefit from being cleared under our umbrella, or the risk might be to a point where it is just not worth it for us to clear them.

The CHAIRMAN. Well, I think the Committee understands that, too. That is why we proposed some exemptions. But, what I am trying to get at, bottom line here, is to get the risk of these transactions at least put out there someplace by some independent party so the risk doesn't end up being on the taxpayers again. That is where I am coming from. So we are probably not in that much disagreement.

Mr. DUFFY. No, we are not.

The CHAIRMAN. A number of you mentioned these provisions on the ban on naked credit default swaps. Some of you don't like this idea. So, for those who don't like the idea, and I guess the ones that do, you can comment on this. There are other alternatives that we looked at.

Here is where I am coming from on this: When we had this situation with the SEC banning the naked short selling of stock, I had some people tell me that by not having a similar ban in the CDS market we actually put some people in a bad situation where they couldn't basically protect themselves.

So one of the ideas is that we would have the provision only apply when the SEC bans short selling of stock; there would also be a ban on short selling or naked short selling of CDSs. If that were the provision, would that change your position on what we have proposed, if we changed it? Mr. Damgard?

Mr. DAMGARD. Yes, I would continue to argue that this ban really would dry up liquidity at a time when we don't need it. I am sure that the SEC has looked long and hard at their decision. I mean, they reversed themselves because the options industry came in and said, the only way we can operate is if we can sell short; and, as a consequence, the SEC reversed that. But I do think better coordination between the CFTC and the SEC is certainly a laudable goal.

The CHAIRMAN. But does it create a situation, though, where people could move against a company if the SEC does have a short selling ban?

Mr. DAMGARD. I would yield to Mr. Gooch on that. I think he is really the expert on the commodities defaults.

The CHAIRMAN. I don't know enough about this. I know enough to be dangerous.

Mr. GOOCH. Mr. Chairman, first of all, you have to look at equities and credit in sort of the opposite role. So if you were banning the short selling of the equities, you would ban the buying of the credit derivatives. You buy the credit derivative because you are basically buying protection against a default. That would be going the same direction in the market as selling the equities. Because if a company defaults, its equities are going to be worthless as well.

So, the concern is that when the banning of short selling in the financials took place, it was sort of an emergency situation because we were in a death spiral, which was contributed to by the mark-to-market rules on the banks. I would say that 98 percent of the time I would want to know what the assets my bank has are worth. But in certain very unusual circumstances it might be necessary to have some kind of circuit breaker in place that would allow some breathing room so that you don't have this death spiral that occurred back in September, when there was the buying of the credit derivatives and the selling of the equities. Because that would be where you would potentially hedge a short credit derivative position and, at the same time, the run on the capital of the banks, as their equities were declining with the necessity then to find liquidity. This means selling more assets in fire sales, and down the spiral goes.

I would certainly think that 98 percent of the time you don't need to worry about this. But in situations where we are in a very difficult financial environment, maybe there should be some kind of circuit breaker that would address all the markets. But, at the same time, once again, you need global cooperation, because you can always trade these things outside of the U.S.

Mr. GREENBERGER. Mr. Chairman?

The CHAIRMAN. Mr. Greenberger.

Mr. GREENBERGER. If I could address the question, I would urge you to keep the provision in the statute.

Mr. Gooch talks about CDS buying protection. We are talking about naked CDS. With naked CDS, there is no need to protect. It is a bet that, in the case of subprime mortgages, that the homeowner will not pay his mortgage or her mortgage. These get paid off if the collateralized debt obligations fail. The collateralized debt obligations are a security interest in homeowners paying their mortgages. These are people who don't have the security interest in that.

John Paulson, in 2007, took out these naked credit default swaps; and because there were so many forfeitures of your constituents, he was able to take home $4 billion that year. Now, he was lucky, because he got to the window when the people who were issuing the guarantees still had money. AIG ran out of money. And, by the way, you and I and your constituents are now sending money in the front door of AIG and Citigroup and others, so it will go out the back door to pay people who took a naked bet that homeowners would not pay their mortgages.

Because you are having bets out there that have no reflection of the real economic debt, as Eric Dinallo told you, it is magnifying the problems by threefold, somebody says eight-fold. In other words, more people are betting the mortgages won't be paid than there are mortgages.

With regard to your correlation between the SEC short and this, I believe that Chairman Cox, a former Member of the House of Representatives and President Bush's Chair of the SEC, wants to ban naked credit default swaps because it is a way to get around the regulated equity markets. In other words, if you think GM is going to fail, you buy a naked credit default swap on GM, even if you don't own a bond in GM. And then what do some of those people do? It is reported they go out and take every action they can take to encourage the failure of GM.

In the case of insuring subprime loans, Barney Frank has made the point that when banks have gone in and tried to renegotiate to leave people in their houses, that hurts the people who have guarantees for the failure. So they are bringing lawsuits to prevent that renegotiation.

These naked credit default swaps create the grossest form of moral hazard. From 1789, when this Republic was founded, to the mid-1990s we didn't have credit default swaps or naked credit default swaps.

I ask you, are your constituents, when you go home, saying, please, please, please allow us to have naked credit default swaps? No. It is the bankers who got us into this problem who want these naked credit default swaps. They should be banned; and I believe if this Committee doesn't do it, it will be done by the SEC. And it will be the first step in the pillar to say the CFTC is not doing the job, let's get rid of it and put it in the SEC.

The CHAIRMAN. Thank you very much. My time has expired.

Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman.

Would anyone else on the panel like to comment on what Mr. Greenberger just offered up? Please, Mr. Duffy.

Mr. DUFFY. I will just make a quick comment, only because I can't help it.

You have to look at what happened here. When you talk about naked credit default swaps and credit default swaps in general, what we have proposed is to have a clearing mechanism for credit default swaps, which we think eliminates a lot of the risk associated with these products.

What is critically important for credit default swaps or any other product is liquidity. If you don't have liquidity, *bona fide* hedgers are not going to be able to move in and out of their positions at all. Because the bid offer will be so wide you won't be able to transact any business, whether it is in grains, crude oil, or credit default swaps. So these people are essential to both sides of the marketplace.

So, when we talk about mandatory clearing of these things, it is a little bit different than a bilateral transaction by AIG, who was completely under-collateralized and didn't have the risk management capabilities to facilitate this market, of which they were only two percent of the entire CDS market. So there are a lot of differences in here that need to be cleared up.

Thank you, Mr. Lucas.

Mr. DAMGARD. It is a slippery slope. I mean, Mr. Greenberger confuses manipulation with speculation. Clearly, a stockholder of General Motors is entitled to sell his stock. But should only a stockholder of General Motors be able to sell that stock, or should somebody be able to speculate outside of whether or not he is a current stockholder or not?

I mean, it seems to me Mr. Duffy is absolutely correct. At a time when credit is so tight, anything that limits the liquidity of the credit market is a bad idea. I am simply willing to debate Mr. Greenberger anytime, but I don't know that this is the right place.

Mr. GREENBERGER. Well, Mr. Damgard should not only debate Mr. Greenberger, but he should debate Mr. Volcker, and Mr. Greenspan, who has said, "I made a terrible mistake when I allowed these credit default swaps to be deregulated." He should debate Mr. Cox, who was Chair of the SEC. He should debate Mr. Geithner, who has now talked about putting these things——

Mr. DAMGARD. This is wasting time.

Mr. GREENBERGER. Mr. Damgard, the American public is flat on its back. They don't have a fancy suit and a fancy tie and represent all these bankers. Please let me finish my statement. You interrupted and said that the Committee didn't want to hear what I had to say.

Mr. DAMGARD. I didn't say that.

Mr. LUCAS. Gentlemen, I control the time as the questioner. You may proceed. But there will be a fair and equitable distribution of time for everyone to respond.

Mr. GREENBERGER. Thank you, Mr. Lucas.

I just want to say the American taxpayer has now guaranteed $6 trillion of the banking system. A large part of that amount is unregulated credit default swaps.

Mr. Volcker says that Mr. Greenspan, who was a great advocate of them, has said, "I made a terrible mistake." Mr. Cox, a Republican, who was a Member of your House of Representatives, has called it a regulatory black hole and in September urged immediate action.

There is an exemption provision in your draft discussion. If any of these naked credit default swaps are so important to liquidity— and, by the way, the liquidity here is being given by the American taxpayer. These credit default swaps are operational today because we, as taxpayers, are giving AIG, Citigroup, Bank of America, and Merrill Lynch money to pay off these bets. They have no economic purpose. They have dragged the country into a mire.

Two percent of the market—there are estimates out there that for every one credit default swap insuring real risk, there are eight that are bets that mortgage homeowners will not pay their mortgages.

Mr. LUCAS. Thank you, Mr. Greenberger.

Mr. GREENBERGER. I think that is a terrible thing. It creates high moral hazard, and the Chairman is absolutely right in putting that provision in his draft discussion bill.

Mr. LUCAS. Mr. Gooch, do you have any thoughts?

Mr. GOOCH. Yes. I think that there is a danger in doing something drastic with a marketplace that exists now that is very liquid, and has actually functioned very well throughout the credit crisis.

I would just like to point out that the taxpayer, in any case, in the United States of America, 50 percent of the country doesn't even pay taxes under Obama's tax plans; and so they are not picking up the tab. During the boom, when things were going very well and profits were being made, the government was taking a 35 percent corporate tax, the government was taking 38 percent, 35 percent taxes on incomes, and 15 percent capital gains. So, during the boom times, the government was taking more than 50 percent of the upside.

And when you go through a cycle, which this one happens to be extremely severe, the government needs to then become involved in stepping in and paying their fair share in stabilizing the marketplace. But to step in now and kill the credit derivative market at this point in time where we are very delicately trying to get banks to lend, and they won't lend until they get these bad assets off their balance sheets. All this money that is sitting on the sidelines is willing to sell credit derivatives, which reduces cost of borrowing; and they won't be willing to sell them if they can't buy them naked.

You will kill the credit derivative market and, in my opinion, extend the recession, possibly even creating a deeper recession for a very, very long period of time.

Mr. LUCAS. Thank you, Mr. Gooch.

If the Chairman will indulge me, Mr. Cota?

Mr. COTA. Let me be very brief.

These are very complex financial instruments; and, to the extent that they are complex, don't just give up and let it pass. It is the scale of these that are staggering. The estimate for the credit default swaps is somewhere between $40 and $60 trillion of value. If you add in the other derivatives that may apply under this regulation, it could be as high as $500 trillion, according to some news reports. Those are so many times the size of the U.S. GDP or even world GDP that it is so significant that it needs to be dealt with. And that is where my expertise ends.

Mr. LUCAS. Thank you, Mr. Cota. I yield back.

Mr. BOSWELL [presiding.] Thank you, and I appreciate the discussion.

Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman.

Mr. Gooch, in your testimony you said that if the major investment houses had failed, in your opinion, the clearinghouses, the various futures exchanges, would have failed as well. That would mean CME, Mr. Duffy. I think that was what Mr. Gooch had in mind.

You also have this statement, since the large banks and prime brokers represent the bulk of the clearing capital at risk, it makes sense that a clearing solution provided by those banks with a high degree of transparency on pricing and mark-to-market makes the most sense.

Could you elaborate a little bit about that?

Mr. GOOCH. My point with the state of the environment about the credit clearing, so it would be the clearing house in the various futures exchanges, that these large banks and investment banks and SCMs, their capital is ultimately at risk if there is a demand on the capital of the clearing facility.

I think the CME has $7 billion of clearing capital, and then after that it is the margin money that is on deposit, and then after that it is the capital of the various banks. So it is a horrible Armageddon concept, but had there been a major banking failure, which is what Secretary Paulson was concerned about, that weekend towards the end of September, a couple of weeks after Lehman had failed, that if certain investment banks had gone into bankruptcy similar to Lehman, and then there had been a domino theory through the banking system, the futures markets would have gapped wildly.

The margin money on deposit would not have been sufficient to make good on all of the positions in the futures market, and then you would have been going for the very capital of the failing banks. So the clearing facility would collapse with the banking system, and you would simply end up bailing out the clearing system.

Mr. MARSHALL. You have heard many commentators, Professor Greenberger being one, saying that we are exposed to a huge systemic risk as a result of these naked CDSs. The Chairman has suggested one possible solution, which is simply to ban the naked CDSs. The response is very much like the argument that we had last summer concerning the underlying bill to which we have added the CDS provisions, and that is that traditional speculation is necessary for liquidity in these markets. It can provide all kinds of benefits. One suggestion that has been made is that if the naked CDSs are all on-exchange, they are all cleared, the systemic risk posed by naked CDSs would be diminished substantially. Do you agree with that?

Mr. GOOCH. I don't necessarily agree that——

Mr. MARSHALL. You don't agree that there are substantial systemic risks presented by making the——

Mr. GOOCH. I think having the instruments in a central environment where you can see everything optically is helpful for regulators so they can see where the risk lies. But, certainly, margining for credit default is very complex. I mean, I give the example of Lehman. Their senior debt was trading at 85¢ on the Friday before they went into bankruptcy, and on Monday morning it was trading at 11¢. I don't see how you could effectively margin for that level of price move over the weekend.

Mr. MARSHALL. What some are searching for here is a compromise position where folks like you could say, by adopting the compromise, the exposure—and not necessarily the market manipulation part of this, which is a separate question. Mr. Damgard is right about that—but the exposure that we have caused by this notional value, which is huge, has diminished substantially.

Are you suggesting that it really doesn't matter whether or not you have an elaborate clearing mechanism set up, you are still exposed; there is no way to lessen the exposure systemically?

Mr. GOOCH. I still think there is potential risk, but my point is that you do need the major banks whose capital is ultimately at risk in that clearing mechanism to be cooperating with the clearing process. That is my point.

Mr. MARSHALL. Do they need to be the members?

Mr. GOOCH. They are the members, but, that you definitely require their cooperation. But you also require global cooperation, because these instruments are also traded throughout Europe. So you can't have a clearing mechanism that considers that all of the transactions are only in the U.S.

Additionally, of course, there are highly illiquid instruments that just dump themselves for clearing, and that the financial system benefits from the willingness of investors to put capital at risk that provides liquid markets. I am a free marketeer myself, so I believe that it is important to have free liquid markets. If you create price controls, you create shortages.

This price control, which is what it would amount to be, would be creating a shortage of credit. You know, blaming the CDS is like shooting the messenger, because the CDS were the instruments that were certainly used in the financial markets, but there was no ultimate failure in the CDS market. The CDS markets performed perfectly.

What is failing is the mortgages and the lending that was done to persons that shouldn't have been borrowing. And to that extent we have a sort of global responsibility for having just enjoyed living beyond our means and having a massive global credit bubble, and that credit bubble also drove oil prices to $140.

I mean, until it burst, investors overseas that would be concerning themselves with the future needs of the growing economy in countries like China, buying up oil reserves, was what partly was driving the price of oil.

So it is not the credit derivatives that are at fault, it is the entire free, cheap credit in the system that was the problem.

Mr. MARSHALL. Thank you, Mr. Gooch. My time has expired.

Thank you, Mr. Chairman.

Mr. BOSWELL. The chair recognizes the gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

I want to go to kind of an example here, because I heard several of the panelists saying that these are challenging credit times, and so we don't want to do things that could inhibit the credit markets.

Mr. Cota, I was actually thinking about your company as I was going through that scenario in that there are a lot of companies around the country who may have very, very large contracts with one or two customers that make up a huge risk to that company. So, they go to their banker, and they ask their banker to factor their receivables, or to loan them operating money, based on the amount due them by some of these very large companies.

Now the banker, if he is trying to work with you, may try to hedge his risk to your customer, because he knows that, "so goes your largest customers, so goes you."

So, when we start limiting the ability for lending institutions, or the people they provide capital to in this very choppy water, we are, in fact, inhibiting the ability for the financial systems and the financial institutions to help us.

Now, government's role here is transparency and integrity, but I have heard people say that we need to control these markets. Well, I certainly think you don't want the United States Congress controlling these markets. Is there something, is there a flaw in my thinking on this, Mr. Duffy, or Mr. Cota, do you want to respond to that as well?

Mr. COTA. Yes. With regard to risk of customers and those sorts of issues, that risk did present itself. In July, prices had stayed where they were at. Just my possible margining of positions would have created a huge cash-flow issue that most banks would not have loaned into. Generally what banks will do is they will loan on the basis of inventory and assets, the principal asset being the receivables. They took a look at the amounts required at that point for our industry; it would have been multiples of company values. So the bank also looks at what the underlying company value is, because the receivables go to a zero value if you don't stay in business, so that is a risk.

On the positive side of how it affects banking, it is the largest banks that have dried up the liquidity in our markets. My market region, actually the small business banks and the small banks in our region are deposit-based lending, so they have tons of money. They are actually encouraging me to go out and do additional work right now to deploy capital that they need to put to work. It is only the large financial institutions that didn't have prudent reserves in order to be able to do that.

So the impacts and risks are there. I think that if you are prudent, and you don't necessarily give authority to Congress, but to the CFTC, we can get more of those credit requirements that would lend itself to prudent business relationships.

Mr. NEUGEBAUER. Thank you.

Mr. Duffy.

Mr. DUFFY. I agree with Mr. Cota, what he said.

Again, from our standpoint, liquidity, as we talked about it earlier, is critically important to our participants. What we had seen throughout some of the increase in prices is really the credit prices affecting our clients where they weren't able to get credit to finance the hedges they had on the books of the exchanges, and in return they had to liquidate those positions.

So that is one of the things we have seen. But it is not so much a fundamental flaw of the price or the product; it is the fundamental flaw in the credit. We could not get the credit.

Mr. NEUGEBAUER. Don't, in fact, these CDSs in many ways provide some other tools for people to manage those risks?

Mr. DUFFY. Yes, they do. Credit default swaps are a very valuable tool in this economy that we live in. Just maybe to touch on it real quick, one of the things that we think about with clearing these products, we eliminate the systemic risk associated.

One of the things that Mr. Gooch didn't mention is that we would not clear these like traditional futures contracts. We are talking about having 5 days' margin up. We are talking about a minimum $300 million per account. We are not talking about having $25,000 like you would margin an S&P futures contract.

So there are huge fundamental differences in clearing credit default swaps that are S&Ps, crude oils or grains. So we think that by netting it down, we have already figured we could net the credit default swap market down by a factor of 5:7 by compressing it in our clearing house. It is already at $27 trillion and shrinking off of $63 trillion.

So this is a market that we think, with our expertise, we could certainly manage risk much better and help free up more credit and go through the system.

Mr. NEUGEBAUER. Mr. Damgard, do you want to respond to that?

Mr. DAMGARD. Yes, I would agree with that as well. Even Mr. Buis' part about corn, I mean, the reason you couldn't sell your corn is—and I sold some over $7—because the elevators don't own the corn. The elevator is storing the corn for the farmer. The farmer wants his money, and the elevator goes to the bank or the CoBank, and they say, "We can't loan you any more money because you don't have the assets to put up."

So to the extent that all of this really relates to credit, it seems to me whether it is the cotton market or whether it is the corn market, the last thing we want to do is tighten up on the credit market right here. I agree with everything Mr. Gooch had to say.

The CHAIRMAN [presiding.] I thank the gentleman.

The gentleman from Wisconsin, Mr. Kagen.

Mr. KAGEN. Thank you, Mr. Chairman. Thank you very much for holding this hearing.

Mr. Buis, you have been sitting on the sidelines here for about the last 45 minutes. How are things really working for farmers and farm families across the country?

Mr. BUIS. Well, thank you, Congressman. I was enthralled by the debate that was going on here, and certainly trying to follow along on those credit default swaps.

Things on the farm are not good, and this deregulatory approach, or the lack of oversight by CFTC, has led to it. Farmers thought they were going to get good prices. They were precluded from the market, and Mr. Damgard is right, they ran up against their credit limits.

But what they don't tell you is that those markets were going up, not because of market fundamentals, but because of the tremendous amount of Wall Street money that came into those markets. And everyone saw this as a great opportunity to make money. As a result, you gave false hopes to the grain farmers that they were going to get these prices. They were precluded. You gave false hopes or big scares to the livestock industry because they thought the prices were going to continue to go higher and higher, so they locked in feed costs. You gave false hope to the ethanol industry, the biodiesel industry, all the processors that, to hedge themselves, they paid higher prices because the big fear was that it was going to continue. And when the bubble burst, and when commodity prices collapsed, it has virtually impacted every aspect of agriculture.

Mr. KAGEN. So now your input costs are higher than the price that the farmer——

Mr. BUIS. Absolutely.

Mr. KAGEN.—is going to receive, so they are in a losing position.

Mr. BUIS. In a very losing position, and they are locked into these higher costs, whether it is livestock producers or grain producers. Buy fertilizer based on record inputs, and fertilizer prices followed oil, and we all know that was a false bubble as well.

Mr. KAGEN. When do you expect the consumers to feel the impact of that?

Mr. BUIS. Well, the irony is consumers aren't feeling the impact. You know, wheat prices were $23 a bushel on the Minneapolis Exchange last winter. They are now down around $6, and the price of a loaf of bread has gone up over $1 this year. So that would be another subject for another hearing, Mr. Chairman, Members of the Committee.

Mr. KAGEN. Mr. Greenberger, Mr. Gooch has suggested that the credit derivatives market is transparent. Do you agree with that?

Mr. GREENBERGER. I don't, I don't, and I want to make a point about the worry about credit.

We know today there is no credit in the markets. Why is there no credit in the markets? Because everybody is worried that somebody else holds these private, bilateral contracts that have nothing to do with helping people get mortgages. They are simply bets that people won't pay the mortgages, but they are trillions of dollars of debts.

If Lehman Brothers fails, if Bear Stearns fails, if Fannie and Freddie fail, if Citigroup has spent $300 billion of their troubled assets thing, everybody is saying to themselves, we can't loan to anybody because anybody may fail.

Mr. KAGEN. And isn't it true that the notional value of those potential assets are far greater than the real estate holdings, the real market value?

Mr. GREENBERGER. Absolutely, because people are betting. It is just like when you say in the Super Bowl, how much money is at risk——

Mr. KAGEN. Please, let me follow up on a statement by Mr. Gooch, that the banks are illiquid primarily because of the unknown market value of the paper, bad paper, toxic assets that they are holding, because those things haven't been marked-to-market, those things are unsellable at a market price that they can come out with any profit on; isn't that true?

Mr. GREENBERGER. That is exactly right. If you have the legislation that this Committee has proposed would give those credit default swaps that are traded—and, by the way, if you have risk, in other words you have loaned money, and you want to make a risk against it, you can go on Mr. Kelly's exchange and buy a credit default swap.

If you don't have risk, that is the question, should you be able to bet that people won't pay their mortgages or that GM will fail?

Mr. Peterson, in his draft bill, is saying betting is for Las Vegas, not for the exchanges. By the way, Las Vegas, if they regulated the stuff, would have never gotten into the trouble that AIG had. Or, for that matter, if the Mafia had done this, they would have balanced their book.

Mr. KAGEN. Well, I am going to assume they are not in the room, but they might be watching.

Mr. GREENBERGER. Okay.

Mr. KAGEN. But coming back to the point that was made by Mr. Gooch, and that was that the mortgages have failed and not the CDSs, it is just the opposite, because the notional value that is a result of the CDS activity is far, far greater, perhaps to the tune of $50 trillion greater, than the underlying assets of the mortgages in the paper.

I see my time has expired, and I apologize for going over if I have. But, Mr. Gooch, if you would like to make a comment, do you stand by your statement that it was the mortgages that have failed that have helped to create this illiquid condition throughout the global marketplace and not the derivatives markets?

Mr. GOOCH. Yes, I do. The CDS is a specific type of credit derivative that I am concerned about the elimination of the naked risk. If you went to that extent, then I guess you could disallow disinterested parties from buying and selling stock options or shorting stocks. And you could just do the same thing in the foreign exchange markets and the bond markets, and have the same thing in the agricultural markets and have no liquid markets.

My concern with the elimination of the naked-risk trading, the elimination of it in the CDS market, is once you do that, you take the risk-taker and capital provider out of the equation, right now I take the contrary view to Mr. Greenberger that the credit derivatives are not the reason the banks aren't lending. The banks aren't lending because they are concerned about their capital requirements. You have mark-to-market, which I said in normal markets makes sense, and they are reluctant to put money out on the street because they can't get it back in a moment's notice; and they don't want to go to you guys for very expensive preferred equity, so they are sitting there not lending. Finally enough, the only lenders in the market are the providers of credit default swap protection that are still very willing to provide that protection, and that is making it possible for some of the most secure credits to be provided with capital. It is also allowing for these very banks to protect some of their risk they have with certain lending relationships they have now, which, otherwise, they might curtail to an even greater extent.

So, as you know, I only have 18 percent of my business in credit derivatives. If it disappeared tomorrow, we would find something else to intermediate, probably carbon credits. So I am not speaking from my own personal best interest, I am actually talking about the U.S. economy and the global economy.

My concern, as an independent, neutral marketplace for credit derivatives, is that if you take it away, you are going to really significantly damage the very fragile credit market we have now.

Mr. KAGEN. Thank you for your comments, and I would finally say that once we restore confidence to the marketplace by providing transparency, we might be able to unfreeze some of that credit. Thank you.

The CHAIRMAN. Thank you.

The gentleman from Texas, Mr. Conaway.

Mr. CONAWAY. Thank you, Mr. Chairman.

At the risk of beating a dead horse, section 16 does give me some pause if for no other reason than a ban on any other kind of otherwise legal activity is always troublesome. I would like some comments as to if, in fact, we do institute this ban, what instruments take these CDSs' places in the market? We have some very bright people out there who will find something else that you and I aren't thinking of right now, perhaps, to do that.

Most of the comments seem to be as a result of the scale and the size of this thing. My view—and I would like your comments—if we had the normal reserve and capital requirements that insurance companies have to abide by when they sell an insurance product—and the CDS is an insurance product—and you had those capital requirements in place, and then you had on top of that the margin requirements on exchanges that further add a protection, that would drop the scale of these things back. You would still allow them to do it, still allow the activity to go on.

I had a conversation yesterday with a friend from Fort Worth, Texas, who is one of those dreaded hedge funds guys. He and two of his buddies scraped together some capital about 10 years ago, and they have been able to parlay that into a lot of money for themselves and their clients, and nothing wrong with that. They are long in the stock market, in this instance mining stocks. They use credit default swaps as a hedge, in their mind, a legitimate hedge, to offset the perceived risk in that, and it worked on their behalf.

So, comments on capital requirements or reserve requirements for folks who write the original contract, CDS, and then as well as the impact the margin requirements would have on stabilizing these things so that if there is a loss, someone other than the American taxpayer pays that loss off.

Mr. Duffy.

Mr. DUFFY. Thank you, sir.

Maybe the answer to your first question is what new products would they come up with to trade if there was a ban on credit default swaps or others. I don't think they would. I think they would just trade them someplace else, such as in London. So they would continue to trade the product of credit default swaps.

Second, I think capital requirements are essential and reserves are essential for this product. We still believe this is a very viable product for participants to use to manage risk in credit default swaps.

But, again, when Mr. Greenberger says that Chairman Volcker, Mr. Greenspan, Mr. Geithner, and others have said that these things should be banned, that is not true. What they have said is they need to be regulated, not banned.

And, that is going to what you are saying, Congressman. We need to come up with ways to make sure there is transparency and people can use risk management for these products so we don't have systemic risk so it is coming back for the taxpayer to be bailed out.

So we completely concur with that, we agree with that. No one likes going back to the government to be bailed out. We believe that a cleared model for credit default swaps makes complete sense, recognizing that there are certain ones that are just not potentially clearable, and we may have to trade off-exchange.

Mr. CONAWAY. Mr. Damgard.

Mr. DAMGARD. I would agree. I would say there are a lot of legitimate businesses out there that used the futures market and used credit default swaps for their own protection, as you just evidenced. The credit default swaps are not going away. There are very, very fine markets outside of the United States, both in the listed derivatives business and the unlisted derivatives.

It seems to me anything we do to encourage people to use markets outside of the United States diminishes the CFTC's and the SEC's ability to see what is going on. This would be a perfect example of taking business that is creating jobs in the United States, it is providing liquidity, and moving it offshore.

Mr. CONAWAY. Mr. Greenberger, 30 seconds max.

Mr. GREENBERGER. I would just say I agree with you completely about capital requirements. Your state insurance commissioners are doubtless right now thinking that the CDS is insurance of a risk or unlawful insurance of no risk.

If there were capital requirements, that would be very helpful. If there were collateral requirements, that would be very helpful.

Mr. Marshall is looking for a compromise here. If you require people who entered into these transactions to have the capital to pay them off and collateralize their things, yes, that would be an adequate substitute to an absolute ban.

Mr. CONAWAY. Thank you, Mr. Greenberger.

Sections 4 and 5 talk about detail reporting, transparency and that kind of thing. I am a CPA by background, and one of the ways to whack somebody is to regulate them to death, and I am not experienced enough in this kind of reporting to understand that—are we overreaching, Mr. Duffy, Mr Gooch or Mr. Damgard? Talk to us about sections 4 and 5 real quickly. Is that too far, is that okay, is it a subject you can comply with?

Mr. GOOCH. I am not entirely sure what sections 4 and 5 say because I was focusing on 14 and 16.

Mr. CONAWAY. Okay.

Mr. GOOCH. But I would just like to add that I do support, and my firm is in favor of, what the Committee is trying to achieve in trying to find transparency and regulation in the marketplace. My concern is simply not banning something in some kind of knee-jerk reaction that could actually do more damage than good.

Mr. CONAWAY. Mr. Duffy, 4 and 5, you guys, can you confer with that?

Mr. DUFFY. You know, I had to just confer with counsel, but right now, sections 4 and 5, it just is a lot of daily reporting activities. We don't have issue with what you are doing on these two sections, sir.

Mr. CONAWAY. We would like, if there is anybody else out there that has any comments about how they would actually comply with that, and if that is such a stifling burden, we may adjust it.

Thank you, Mr. Chairman, I yield back.

The CHAIRMAN. I thank the gentleman.

Mr. Schrader, the gentleman from Oregon.

Mr. SCHRADER. Thank you, Mr. Chairman. I appreciate that. I guess I am concerned about some of the credibility of what we have heard today.

I mean, I am a new Member. I won't pretend to understand some of the arcane notions of derivatives and futures trading, but I do know that for most of this country's history, we didn't have any credit default swaps, and we seemed to get along okay.

I also find it interesting that most of the people affected by naked default swaps are in favor of this legislation, namely the agricultural community and the petroleum marketers. That speaks volumes in itself to whether this is, as such, a bad piece of legislation, and it is so incomplete in its scope. I am curious why the people that are most affected seem to be totally in favor of most of this piece of legislation.

To me, I guess I need to hear from Mr. Damgard, Mr. Gooch and Mr. Duffy. Do they or do they not believe that speculation, rampant speculation, speculation holocaust is indeed part of this problem that we are enduring right now in this economy.

When I hear people, Mr. Duffy, say CDS is a very important tool in the economy we live in, well, I would suggest that the economy we are living in is not too good right now. I do not subscribe to that philosophy of the CDSs, or certainly naked CDSs. My folks back home would ban them. They would get rid of hedge funds, they would get rid of CDSs altogether. I understand that there is somewhat of a lack of understanding in some of the way the market works right now. But I certainly think that this modest proposal is certainly acceptable, and I guess we need to hear from you gentleman if you don't think that speculation, rampant speculation, has anything to do with the problems on our farms and our petroleum marketers, gas stations back home.

Mr. DAMGARD. Well, I would say speculation has been demonized to the point where people think speculation is the same thing as manipulation. We speculate all the time by buying stocks, selling stocks. The people that are using futures markets historically, Mr. Congressman, have been institutional users that know precisely what the risks are, and they use those markets for price protection.

We have seen those markets expand every year for the last 20 years with one exception, and it is really a credit to this Committee and the education that has gone on that has gotten more and more people involved in these markets that are used primarily by people that are managing risk.

Now, without speculators, they wouldn't be able to do that, and the spreads would widen.

So speculation is——

Mr. SCHRADER. I am talking about rampant speculation *versus* investment; it is a big difference.

Mr. DAMGARD. I think you have to trust the CFTC. There are spec limits on speculative traders that are not there for the hedgers. The CFTC has a pretty admirable history in making sure that these markets have worked as well as they have. Random speculation, or outrageous speculation, is something that, in my judgment, is left to the decision of the people in the Surveillance Department of the CFTC, and to legislate hard and fast rules, particularly as these markets expand, is pretty dangerous.

We want speculators in these markets. We want hedge funds in the markets. We want pension funds in the markets. Clearly, an awful lot of the money that was made in the rise in the price of oil was pension funds and endowment funds that had deserted the equity markets. The people that manage those endowments recognized that there was more opportunity in the commodity area.

There have been a lot of adjustments in our market since the advent of electronic trading. It used to be that certain markets, particularly when it was floor-based, were kind of a club. With electronic trading, everybody that has access and money to an account with a clearing member has the opportunity to invest in whatever they want to invest in.

Mr. SCHRADER. I appreciate the testimony.

I would like to hear from Mr. Gooch and Mr. Duffy. I understand rampant speculation is okay with you.

Mr. GOOCH. No, certainly not; that is subjective. I would not be in favor of rampant speculation. I mean, there are situations where the Hunt brothers cornered the silver market way back in the past. Clearly there has to be some regulation in that respect. I don't think you can just have—when you use the words "rampant" and "holocaust," obviously, that would be bad. But to then take all speculation——

Mr. SCHRADER. I think it is pretty bad right now.

Mr. GOOCH. Well, you say that, but at the same time the United States, even in this significant downturn, still has the highest standard of living in the world.

Mr. SCHRADER. Well, we are going the other way as hard as we can.

Mr. GOOCH. The entire world was over-leveraged and went through a credit bubble that may have significant causes other than the various instruments that we used to transact the risk.

Yes, I completely support the concept of centralized clearing, but I agree with Mr. Duffy, not all products could be put into centralized clearing. Regulation, transparency and limits, limits on positions relative to capital and things like that, those things all make sense.

Certainly, AIG should not have been selling credit default swaps and pocketing the premiums and treating it as if it was income. They should have been far more conservative. But there is always, throughout history, the case of either individuals or corporations or governments that overspeculate, and they should be held to some kind of limits.

The CHAIRMAN. I thank the gentleman.

The gentleman from Ohio, Mr. Latta, has he left?

Mr. DUFFY. Mr. Chairman, may I make a comment, sir?

The CHAIRMAN. Yes.

Mr. DUFFY. I didn't have a chance to answer the Congressman. I think it is important for the record that I do so, right, because he talked about not having credit default swaps around or anywhere else as of 10 or 11 years ago, and that is absolutely true. But you also have to remember that product innovation in financial services is as critical as it is to research and development of any other business. So in order for economies to grow, we need to have new products that people can manage their risk properly with that to help us continue to grow and bring us into new centuries. So, that is really important for product innovation to move forward.

And as far as rampant speculation, when you look at regulated exchanges with limits proposed on their trading, spending a big part of a portion of their own budgets—we are public companies—to make certain that we don't have rampant speculation that could turn into manipulation, it is critically important to the success of any publicly traded company such as CME Group.

So, no, we don't condone excessive speculation or rampant speculation, as you put it, sir, but we do believe that there is a buyer for every seller, a seller for every buyer. The more liquidity there is, the better price the person that is trying to hedge their risk will get for the product.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

The gentleman from Nebraska, Mr. Fortenberry.

Mr. FORTENBERRY. Thank you, Mr. Chairman, for holding this very important hearing and for delving very deeply into this complex issue, and I thank the panel as well for the lively and informative exchange. It has been very productive.

When gasoline went over $4 in Nebraska last year, I stopped in to see Bill Sapp. He does something similar to you, Mr. Cota. Any of you who have gone down Interstate 80 right outside of Omaha might see a big coffee pot sitting 100 feet in the air. That is Bill's business. I said, Bill, what is going on, and he said, speculation.

I want to follow up with your comments, Mr. Cota, talking last year when we hit $140 or so on oil futures, and now we are back down to $40. Your suggestion that this is being driven by greed and fear, being untethered from any supply or demand conditions, simply being accelerated because of artificial factors, outside, again, of the underlying fundamentals, led to such disruption not only in terms of gasoline prices, but all of the other commodities. And you, sir, had mentioned consequences for the other agricultural markets.

If we presume that is true, and last year we held numerous hearings on this with the CFTC to figure out what systemically was potentially failing, where has regulation gone wrong. Their conclusion was we can't find a smoking gun, but we need more time and more help to potentially find a smoking gun.

Let us unpack the reasons for, again, that rapid spike in speculation that everyone agrees has been terribly disruptive and not normal. Mr. Gooch, you alluded to it, to a portion of the reason, maybe the significant portion, in terms of credit and credit bubbles and investing in commodities as an inflationary hedge or for other reasons, because people were just getting on this accelerating train.

If we can get to that underlying question, and then we know a lot more as to how to potentially prevent this type of systemic failure, disruption into the future, which has been, again, underlying a big portion in this economic malaise that we are in.

Mr. COTA. Congressman, first with regard to your comments on the CFTC in that they didn't have enough information in order to determine whether or not there was speculation having an impact, that is because they don't have jurisdiction over large chunks of the market through various—closing the Enron bill does take part of that, but those administrative rules are not in place yet, and it still exempts the lending loophole in all of those. So until you start counting the whole pie, it doesn't make any sense.

The case of Amaranth, which was a hedge fund that went bad, they only got caught because they did some of their trades upon a regulated exchange, a subsidiary of the Chicago Merc, the New York Mercantile Exchange, where they were cornering—it was perceived that their positions were too large for the February contract.

In retrospect, after an investigation, it turned out that they had 80 percent of the U.S. total natural gas production for the February contract, just for their position. So until you see what these aggregate position limits are of these large entities, and you keep track of it, that is the only time you can bring it to the light of day. I like to have exchanges do most of this, because you put all of the players together in the same room, and they know what is going on. When they see somebody is going to put them at risk, they are going to be much more diligent and make sure that person doesn't.

As to what started the whole process, we started when the subprime market went bad, so people needed to put their money as they sold out of that. The banks that lost money on that initially lost because they had loaned money to people to buy these subprimes, and then they decided it went as high as possible, so I had better short it.

So they shorted it. People they loaned money to went bad. People needed to move money out quickly. Any pyramid collapses faster than it went up, and then they went into their remaining items. The remaining investments were equities at that point, so in 2007 you saw a bump in equities. As that started to come apart, it moved into currencies and commodities. It was the only thing that was cash. As people became afraid of everything else, a stock may go to zero, Lehman may go to zero, a commodity will never go to zero. It may go to 2¢ on the dollar, but it won't go to zero.

So the investing world was so afraid of any sort of investment. The banks didn't trust one another so that they went into the few things that they thought were left. That, to me, underscores the issue that you need to have sensible regulation.

The world looks to the United States to have the most coherent regulation of financial markets in an open and free market—so that you can trust your money is going to be worth something. The other markets around the world don't have that. I am a kind of a contrarian to some of the conversations here—if you do have a well-regulated market in the United States, the money will flood back in because they can trust this market. They may not be able to trust the others. That is my analysis of what occurred.

Mr. FORTENBERRY. Thank you.

The CHAIRMAN. I thank the gentleman.

The gentleman from North Carolina, Mr. Kissell.

Mr. KISSELL. Thank you, Mr. Chairman.

Thank you, panel.

I am going to approach this a little bit differently than Mr. Damgard and Mr. Gooch. Mr. Gooch, you said you had thought the system functioned very well, and maybe I am interpreting it wrong, but it seemed to me it functioned well because there was no major train wreck like we saw in the financial end; the banks weren't collapsing and so forth. But from the perspective of the individuals, the families in my district and across this nation, there were millions of train wrecks.

I am interested in your idea that the system functioned well when the speculation that took place caused so much hardship for our families, and created such an economic crisis of energy and food and other hardships on our families. So how could the system maybe be tweaked so that it continues to function well in some regards, but it offers protections to our families where those small train wrecks are taking place?

Mr. DAMGARD. Well, I was speaking specifically of the futures markets. The futures markets did work extremely well, and they worked very well under the rules that this Committee has established for the CFTC, and that doesn't mean that there wasn't speculation and that there weren't bubbles in some of these markets.

Having been here for years and years, I have been here at hearings where our producers were angry when the price was high or the price is low, depending on what their producers, and users are just the opposite. We did have enormous volatility in the oil market. The CFTC study, as I recall, determined that most of the speculators were basically decreasing their positions in the first half of last year, number one; and, number two, they also indicated that most speculators had spread positions, which means that they were both long and short, and that suggests that there was an equal amount of pressure on buying and selling.

So it may be that the oil speculators are being blamed for more than they should be blamed for. I don't know the answer to why that market went up, but I remember at the time that the criticism was that these funds had all moved out of equities, and they were so-called passive investors. Well, at $145 they got out of the market, so they weren't all that passive. Now we have $40 oil, and we have people that have pension funds that are complaining that somehow the decrease in the value of their pension fund is the direct result of speculators selling the oil price.

So, I have gotten used to people complaining about high prices and low prices, and how that relates to the average family. I go back to the point that Mr. Gooch made, that the mortgage market and the drying up of credit are the root cause of what we are going through right now.

I represent the futures market, which is the listed derivatives market, and Mr. Duffy and I don't always agree on everything, but I do want to say that people are using that market. They just had another record year.

Mr. KISSELL. Mr. Damgard, I don't mean to interrupt you, but I do apologize. I understand the home mortgage situation, but we were having these problems with these little train wrecks long before the home mortgage became a crisis.

See, I am just curious about the system. How can the system work well when our families are the ones hurting? I can feel tens of thousands of people here and say something went wrong when prices went up that much, and nobody can explain it. That is why I am curious. How should we tweak the system?

Mr. Greenberger, you might have a different point of view on this.

Mr. GREENBERGER. I don't have a different point of view, because Mr. Damgard keeps saying I represent the registered futures market, but he doesn't want the unregistered futures market to be registered.

Yes, the regulated markets function fine. They have spec limits.

What Mr. Peterson in his draft discussion bill is doing is saying we are going to take these markets and regulate them. They will have to trade on the Chicago Mercantile Exchange.

In fact, Mr. Gooch, if he is upset that somehow his software is going to be taken off the thing, he can come to the CFTC and have an exchange.

Please remember, when they tell you there are spec limits not on the unregulated markets, that is what Chairman Peterson is trying to do.

With regard to credit default swaps, those are private, bilateral transactions; nobody can accurately tell you. The estimates are anywhere from $23 trillion to $63 trillion. What Chairman Peterson is trying to do is bring that into a centralized facility so that everybody in the Federal Government knows where these potential time bombs are.

Mr. Gooch says if we had had clearing in September, the clearinghouses would have failed, but we didn't have clearing in September. If we had had clearing in September, AIG would have had to put up collateral, and they wouldn't have just had to make these raw bets without having the capital adequacy. If they had to go on Mr. Duffy's exchange, they would have had to have collateral. A prior recommendation was made here: capital adequacy.

Mr. Dinallo, a New York insurance superintendent, will be here tomorrow and say these are insurance companies, they have capital reserves. As Mr. Gooch said, they were just making bets, taking in the money, never realizing a day would come when those bets would have to be paid off.

Finally, I would say if these credit default swaps are so wonderful, I would advise people to invest in the so-called bad banks that are being established. They are taking those wonderful instruments outside of all the financial institutions because nobody will lend them money when they are on the books, and the taxpayer is going to create a bad bank.

If we called torture "enhanced interrogations," one would think we would come up with a better name than "bad bank," but we can't, because bad banks hold bad instruments that were unregulated. There is a hole in the economy of trillions of dollars, and that is the solution.

The CHAIRMAN. I thank the gentleman.

The gentleman from Pennsylvania, Mr. Thompson.

Mr. THOMPSON. Thank you, Mr. Chairman.

A number of witnesses here today and over the next couple of days will testify that in spite of the draft bill's purposes of promoting transparency and accountability, its provisions will have the unintended effects of disrupting market liquidity, and sending trading activity either offshore or on to otherwise unregulated trading venues.

I am just interested in seeing what your response is to those concerns.

Mr. GREENBERGER. Mr. Thompson, if I can address that question, a lot has been said here today, if we regulate in the United States, they will go to London, they will go to somewhere else. I have been working with the United Nations and other organizational organizations. I can guarantee you, London will regulate this stuff faster than we will regulate it.

Every major central banker around the world is upset that these instruments were deregulated, and, quite frankly, as a loyal patriot, I don't like to hear this, but the blame is being put on the United States for having created this crisis. I know Chairman Peterson went to Europe, maybe he can opine about this, but I have been in front of several international organizations with the central bankers from all over the world, and they are furious with us that we deregulated these markets.

All Chairman Peterson is saying is put these instruments back on a transparent market like the Chicago Mercantile Exchange, who has come forth as a central clearing party here, so we know what is going on; require capital adequacy; and if for some reason those general rules are no good, he has provided an exemption from them to be overseen by the CFTC.

Mr. GOOCH. I just want to clarify a couple of things. Mr. Greenberger mentioned that the assets in the bad banks, so to speak, are credit default swaps, and they are not. Credit default swaps are not the assets that would be taken off the balance sheets of banks. I think they are CDOs, collateralized debt obligations, and CMOs and CLOs and that type of thing that have gone bad. It is not CDS.

So, part of why I am here today talking about not killing the credit default swap market is because of this misinformation. It isn't the other credit default swaps.

The other gentleman asked me what did I mean by, the markets functioned fine. When Lehman finally did go out of business, their credit default swap book settled perfectly with all counterparties. There wasn't this systemic risk that people seemed to fear that was as the result of credit default swaps. So credit default swaps end up getting a bad name.

I am totally in favor of having essential clearing mechanisms, one or more, as long as you have the situation from the major dealers that are actually involved with marketing these instruments. I am totally in favor of that and regulation and oversight. I think it is very important for the marketplace.

But we need to be very careful here today not to get caught up in that hyperbole of blaming credit default swaps when they are not to blame, and risking cutting off a source of credit in the marketplace at a very fragile time in the recovery, hopeful recovery, of the United States and the global economy.

To answer your question, Mr. Thompson, in terms of trading overseas, I will just mention, when I started in this business in 1978, the United States Government didn't allow U.S. banks to spot trade foreign exchange internationally, nor to make your dollar deposits with foreign banks. As a result, there was a massive foreign exchange market and euro/dollar deposit market that traded outside of the United States.

At that point in time, when I worked for a brokerage company in the U.K., we had 300 or 400 employees involved in these marketplaces, and their New York office had less than 20 employees. It was 1979 when they deregulated that and put the American banks on a level playing field that the business exploded in the U.S., which is how come I got to be brought out to the United States, because at 20 years old, I was considered an experienced foreign exchange trader.

But that will give you an example of how the United States was behind in those global markets. Absolutely, certainly, if you squeeze a balloon here, it is going to pop out somewhere else.

Right now, the Russian ruble trades massively in London on what is known as a nondeliverable forward. Russia, the Government of Russia, has no control over that marketplace. They trade the Russian ruble in London on a nondeliverable forward. That is the case with a number of currencies around the world. If the United States wants to put themselves in that position by potentially introducing regulation that stifles their competition in the marketplace, the markets will move overseas.

Just one last quick comment. I don't know much about the agricultural markets, but I do understand that there is some CFTC regulation that requires the elevator owners that buy the grain to hedge that in the futures market. It is because of the margin requirement on those hedges that they couldn't buy grain from the producers, which is why those producers weren't able to actually lock in the high prices when the high prices were there.

So all I would say is it was probably a very good piece of regulation when it was introduced, but it didn't work in a very volatile market. So you just have to be careful with regulation that you have flexibility, but I do certainly support transparency in these markets.

Mr. COTA. Congressman Thompson, you also asked the question about how much liquidity is liquidity. Talking about very dull commodities like energy, the heating oil market is about 8 billion gallons per year in the United States, 7 or 8 billion gallons. That amount in regulated U.S. exchanges is traded multiple times per day. There is no lack of liquidity in those markets.

Now, it is a little bit more complex than that, because those trades also trade other types of commodities, but there continue to be huge amounts of commodities in these markets. The only time that they seem to be illiquid is when you have extreme volatility within these markets, and the last remaining portion of the floor-traded aspects, which are purely floor traded, are options trade. Options trading, because of the volatility, did dry up, and to me that meant that there was too much volatility in the markets because too much money was coming in and coming out. So I kind of argue the other side of that.

Mr. THOMPSON. Thank you, Mr. Chairman.

Mr. DAMGARD. I certainly share your concern about the business moving offshore. The largest agricultural futures market in the world is Dalian, China, and that is because they sent a lot of people over here, and they studied the Merc, and they studied the Board of Trade, and they went back to their respective countries and they built fantastic markets.

Singapore has a great market. Hong Kong has a great market. They both trade energy futures, and they would love to see the market move out of New York to their markets. So, we have to be very cautious to make sure that whatever the Committee does, we don't encourage people to use markets outside of the United States.

There will always be a place for people to speculate, and if they want to speculate in energy and they can't do it here, they will do it elsewhere, notwithstanding Mr. Greenberger, who said we have to regulate credit default swaps—truthfully they have never been regulated. This is all part of the innovation, and what the Committee is doing is extremely proper and extremely appropriate. Nobody is for excess speculation, but I do think that the CFTC knows more about it than anybody else.

Mr. GREENBERGER. Also, I would just say, you will have to decide, possibly, when the Obama Administration—if they do recommend bad banks—I don't know where Mr. Gooch gets his intelligence that CDS won't be part of the bad banks. I am quite confident people like AIG, who owe trillions or hundreds of billions, I should say, are going to want to get rid of those instruments, and they will be in the bad banks.

The CHAIRMAN. I thank the gentleman.

The gentleman from Iowa, Mr. Boswell.

Mr. BOSWELL. Thank you, Mr. Chairman.

The comments that Mr. Gooch just made perked some interest about what is happening to the country elevators.

Mr. Buis, do you have any comment? It seems like I remember something not too long ago as they tried to do their forward hedging and so on, that they couldn't do it because they didn't have any capital for any call or whatever.

Mr. BUIS. Yes, you are absolutely right, Mr. Boswell. What Mr. Gooch was suggesting, if I heard him right, would be the worst move ever. Requiring country elevators to hedge is what keeps them from going bankrupt and farmers and elevators from losing their money. We have been through that period.

Mr. BOSWELL. I think I remember that back in the 1980s, when I was Chairman of the Board of an elevator.

Mr. BUIS. Absolutely. You know, I hear all of us talk about, well, we can't regulate in the United States because China is not going to, or London is not going to. That is not a good reason.

I mean, people's livelihoods are at risk. Rural America lost lots of money off of this effort. I think, as Mr. Cota said, it is because no one knows what the positions were, how extensive the money was, and who held those positions. So how can anyone convince me that you didn't have excessive speculation if you are not even accounting for all the activity in the marketplaces because of the exemptions, the swaps, the foreign market exchanges, *et cetera?*

Mr. BOSWELL. Thank you.

I have a question for Mr. Gooch, but I will yield to Mr. Marshall for the rest of my time. Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Boswell. I appreciate that very much.

I would like to return to this notion of trying to diminish the systemic risk associated with naked credit default swaps by using clearing as the mechanism.

Mr. Gooch, you have made it very clear you don't think clearing is going to work very successfully unless the major investment banks are committed to it, involved in it. You are very familiar with the derivatives market. You have been brokering in the derivatives market for longer than I have been in Congress. Why is it that the major institutions would not be interested in clearing? Do they broker through you? I assume they broker among themselves, and probably don't use your services that much. But why wouldn't they be interested in clearing?

Mr. GOOCH. No, I believe they are interested in clearing. In fact, the major dealers launched their initiative with the Chicago Clearing Corp. that we were part of, back almost 2 years ago, then to begin the process towards creating a central clearing mechanism. But there was the situation that occurred in the summer and through September in the credit markets that then potentially put that behind the 8-ball, because their trading positions became more important in the immediate point in time. Then they have continued and most recently signed a potential joint venture agreement with ICE Clear to create a clearing entity for that purpose.

Mr. MARSHALL. The Chairman led a CODEL to Europe. We had about a week to do nothing but focus on credit default swaps. We heard an awful lot of people comment about the different proposed clearing mechanisms that might be adopted. One of the comments was that having the major investment houses operate the clearing facility was probably not a good idea, that that would increase risk, because it is, as they said in Germany, kind of letting the goat tend the garden. Having an independent entity like CME, for example, might be an important part of the checks and balances process.

Mr. GOOCH. The important thing to remember, though, is at the end of the day it would be those banks and investment banks' balance sheets that ultimately were the security to that clearing entity. So, in one respect, if you insist that the clearing be done in one certain place, where you don't necessarily have the full cooperation of the dealer community because they want to know what is going into that clearing mechanism, and they want to know which counterparties have access to it and, therefore, what is going to be the risk to their balance sheet.

We wouldn't have the capital to be a clearing member in that kind of environment, but I certainly, if I had a large investment bank with a large balance sheet, I wouldn't be interested in putting——

Mr. MARSHALL. You wouldn't want to take an unnecessary risk.

Mr. GOOCH. Right. I wouldn't want to put all of my balance sheet at risk.

Mr. MARSHALL. Professor Greenberger, briefly, you noted that perhaps the problem with the default issues associated with naked credit default swaps is minimized if they are cleared. There has been testimony that a number of credit default swaps won't be cleared. They just, practically speaking, can't. Assuming that they are permitted and assuming that naked credit default swaps, uncleared, are permitted and the CFTC is in charge of granting exemptions permitting that to occur, would it be possible for the CFTC to set some capital requirements—things along those lines that lessen the risks sufficiently to permit that kind of behavior to move forward?

Mr. GREENBERGER. Absolutely, Congressman Marshall. That is doubtlessly what is going to happen. Not only will the CFTC do it but people who come with the exemptions are going to want to say, voluntarily, "By the way, I set aside enough capital to deal with this to get the permission to do it." So you have the best of all worlds.

If capital had been required before CDS obligations had been made, whether they were to protect real interests because you own the bond or own the mortgage-backed security, you are taking a bet. AIG would have had a fraction of the CDS, because it didn't want to set aside the capital. That would shrink the market. And that, I think you are absolutely on target.

Mr. MARSHALL. Thank you, Mr. Chairman.

Mr. BOSWELL [presiding.] Thank you.

Mr. Pomeroy.

Mr. POMEROY. Thank you, Mr. Chairman. I appreciate the hearing and found the panel to be really excellent in all of the perspectives advocated.

I used to be a state insurance commissioner. Honest to God, I have trouble getting my mind around the kind of unreserved risk that we passed throughout the economy on these CDSs. In the end, and over the years, we would have people at this table lauding the innovation occurring in the financial services marketplace, how it enhanced liquidity of our markets, how it allowed our economy to grow.

Well, we now know the truth. It grew like a great big soufflé. It was air, over-leveraged air; and it collapsed. Worse yet, here we are well into the collapse, at the highest unemployment registered in decades, and we don't even know if we are down to the bottom of that darn soufflé yet.

So what has happened by all this innovation, in my opinion, has not been something that has served some terrific end. The notion that we are going to allow credit for risk ceded without any looking at whether or not there is a creditworthy partner providing the backstop, to me is just mind-boggling.

Mr. GREENBERGER. Mr. Pomeroy, tomorrow, Mr. Dinallo will be here, the New York Insurance Superintendent, who was responsible for AIG, by the way; and he will opine along the lines you have said. Actually, in September, the Governor of New York and Mr. Dinallo said that credit default swaps that had an insurable interest should be regulated after January 1st as insurance. He has temporarily ceded that to see what Committees like this were going to do.

A week ago Saturday, I testified in front of the National Council of Insurance Legislators. There were people from North Dakota, Connecticut, New York, all over the country; and they are meeting again in March. Their view is, until they are told that insurance law is preempted, they are going to start treating this like insurance. The swap here for credit default is a premium, a small premium in exchange for a guarantee that something bad won't happen.

Mr. POMEROY. Right. It allowed investors to basically book a value on a collateralized bond obligation because it was backstopped by a credit default swap. The credit default swap provider did not have to post a capital requirement, nor was the credit default swap provider even prohibited from subsequently transferring that to unknown other parties.

Mr. GREENBERGER. And, to boot, people were issuing insurance, this insurance, when people had no risk. It was like my taking out insurance on somebody else's life. That is illegal under state insurance law.

In fact, in England, in the turn of the 19th century, people were insuring cargoes on ships when they were fighting the French. So people would insure cargoes and tell the French Navy the English ship is going out there, to collect; and that is why we have insurance law today.

Mr. Dinallo's point is that he feels he has the power to go after the insurance on real risks. That is, you own a mortgage-backed security and you are insuring against it. But he won't over what he deems to be 80 percent of the market when the insurance is just a bet that somebody is going to die.

Mr. POMEROY. You know, I believe that it would be probably far beyond this Committee—somebody, maybe the Fed, is going to be charged with evaluating systemic risk throughout our economy. We shouldn't have to pass a law, in my opinion, to the Executive Branch with the regulatory and other authorities relative to overseeing the economy of the United States of America that you have to keep an eye on this. I am absolutely aghast as to how this possibly could have happened in the first place.

Mr. Gooch—and I certainly don't say this to pick on you. I think you have been an incredibly articulate representative of your viewpoint. But I am hearing from you a kind of unbowed support for a lot of the free market *laissez-faire* treatment that got us into this mess. Are there points of response that you find acceptable? Is there some common ground across this panel where we can at least begin to forge a legislative response?

Mr. GOOCH. Yes, sir. I am certainly in favor of free markets, but to some extent maybe I have been painted into a corner as somehow not being supportive of this proposed regulation. My strong position here today, and in my opening statement, was in this concept of disallowing naked credit derivatives, because of my knowledge about the market and my concern that you will kill the CDS market. That might be one of Mr. Greenberger's goals, but that it would be a big mistake for the American economy.

Right now, as we know, it is very difficult for anyone to borrow money. The banks aren't lending. But some corporations can still issue debt. But one of the things that is going on in the marketplace right now is those debt issuances are very often now tied to CDS prices. Without the willing sellers of CDS that are your speculators, if you like, but I call them risk takers, who are willing to sell that credit risk, you take away a huge portion of willing lenders. They are synthetic lenders. When they sell a credit default swap, they are not lending the money, but they are a synthetic lender. They are effectively underwriting the risk.

Mr. POMEROY. We are over our time. They are basically the market maker on assessing the value of the underlying instrument.

Whatever happened to underwriting? How come we can't just evaluate what the likelihood is this thing is actually going to get paid back and establish it on the underlying instrument, not a side bet being waged by third parties?

Mr. GOOCH. The insurance companies did historically for a long time sell debt insurance, but it is not a dynamic marketplace. You can get the debt insurance on an entire issue from an insurance company, but you don't have the ability, therefore, to tap additional pools of capital that are willing to effectively be synthetic lenders if you restrict it to just insurance companies.

What I would say has occurred, in that respect, is that this is innovation in the marketplace. Throughout history we have had innovation. We had stock market crashes in the 1920s. We had the introduction of futures in the early 1970s. The over-the-counter markets are five times as big as the future markets. This is all innovation that has helped contribute to the prosperity of the free world. That is why I am a free marketeer.

Now I do recognize that there is always the time in any free market where you will have certain speculative bubbles. I mean, I do agree with this Committee in looking to bring regulation and transparency to that market. We are totally, 100 percent, in support of transparency and also in order—not order limits but limits on the degree of risk-taking that entities are allowed to take subject to their balance sheets.

Mr. POMEROY. My time has expired. Mr. Chairman, I thank you for your leeway.

Mr. BOSWELL. You are welcome.

Mr. Boccieri, pronounce your name for the rest of us.

Mr. BOCCIERI. Boccieri. Like bowl of cherries.

Mr. BOSWELL. Boccieri. Okay. Thank you.

Mr. BOCCIERI. Life is like that these days, I guess.

Mr. Chairman, thank you for your leadership in having this Committee panel assembled here.

Having a bit of an economics degree in college, it is amazing to me that it seems as if we are throwing the laws of supply and demand out the door. We are creating these artificial bubbles with these CDSs that drive price fluctuations up and down that have absolutely nothing to do, in my humble opinion, with supply and demand.

When you have, for instance, oil prices spiking at $4 a gallon, even though there was more supply in the market a year ago than there was previous to that, there seems to be a push away from this notion that supply and demand should be running the market, rather than CDSs. I am a little bit concerned, and confused, about the argument that we are making here today for supporting this unregulated, unchecked, artificial price spike, if you will, of commodities and futures that are very important to American families. Having a stable market, a reliable market that underscores that when a consumer, a family goes to a gas station that they can have a reliable price there that they know was equitable and fairly traded, and that was marked by supply and demand and not by speculation, or manipulation like Mr. Damgard had suggested.

I guess my question to the panel is this, that some of the panel have suggested that we take a broader look at manipulation, and that our concern about the test for manipulation is limited to conscious efforts *versus* those that are unconscious. Manipulation is a crime, and there are penalties associated with it. If the market participants are impacting markets unconsciously, but with the same impact as those who have attempted manipulation, shouldn't they be punished the same as those conscious manipulators?

Mr. DAMGARD. The answer to that is certainly yes, to the full extent of the law. And my only point was don't confuse speculation with manipulation. I think speculation doesn't have to be as demonized as it has been. Speculators have been pretty important to the market.

I believe the CFTC has done an excellent job in determining when there is manipulation in the market. Frankly, that is why you created the agency; and that is one of its foremost goals. In my judgment, there is no evidence, credible evidence to suggest that any manipulation was taking place. They looked at it long and hard, and they looked at the speculators, and there were more shorts than there were longs in the first half of last year when we saw the bubble.

Mr. BOCCIERI. Mr. Damgard, I want to ask a question. I remember reading an article last year where it was suggested that big oil companies were betting on the price of fuel going up. To me, with a simple mind and simple notion, that sounds like insider trading, with respect to the fact that they knew that prices were going to go up because everybody was speculating and betting on the price of it going up, even though there was more supply of oil in the market than there was a year ago. Would you hold those unconscious participants, those speculators to the same criminal standard as manipulators?

Mr. DAMGARD. Yes, but if an oil company was in the market and the price was at a certain point, they could either buy it or sell it. They couldn't go out and sell oil for more than what the world standard was worth. I am not sure what your point is.

Mr. BOCCIERI. But if they are betting billions and billions of dollars that the price is going to go up, and to me part of this artificial control of the market, rather than letting supply and demand control the market, seems to me that that is a bit of—they unconsciously or consciously know that the price is going to go up at some point.

Mr. DAMGARD. I am not familiar with the dynamics of the market at that time, but for every buyer there was a seller in our futures markets. Somebody obviously thought the market was going to go down, or they wouldn't be selling.

If, in fact, there was large trader activity, that comes to the attention of the Surveillance Department of the CFTC, and they investigate that and they examine it. Their track record has, quite honestly, been very, very good. That doesn't explain how the price got to $145, but the price got to $145 because there were a lot more buyers than sellers. Much of the evidence suggests that these were pension funds and endowment funds that had moved out of the equity markets because they saw a better opportunity to benefit their pensioners.

Mr. BOCCIERI. It is everybody else's fault, it seems like. Everybody's pointing the finger. Mr. Gooch has suggested that it was the family who had a mortgage and they lost their job. It is their fault because they had a mortgage. That is like the teenage son who borrows the family car and says, "Dad, I would have never got in a wreck if you wouldn't have lent it to me." It doesn't make any sense to me.

Mr. GOOCH. I would say in any bubble there is always going to be some level of fraud at the peak of the bubble. I am not blaming the person who tried to buy a home and couldn't afford it. I would blame the unscrupulous mortgage broker who encouraged someone to take a mortgage they couldn't afford, on a house that wasn't worth the mortgage, simply because they were going to get a $3,000 commission. In this circumstance where you have had 7 years of extremely cheap credit and the global, spectacular growth throughout the world's economies, that is what has driven all of these commodity prices up to record levels.

I don't know enough about those energy companies. I wouldn't jump to the conclusion that they were involved in insider trading because they imagined the price of oil would go up. I mean, frankly, who knew? Right? Sitting here today we all can see that everybody right up to the highest levels of government isn't able to predict the future that clearly.

Mr. GREENBERGER. I would say the reason they are unable to predict the future that clearly is that a large portion, because of the Enron loophole, the London loophole, the swaps loophole was completely outside of the government's ability to see what was going on. The effect of Mr. Peterson's draft discussion bill is to bring transparency to those markets so everybody else knows what is going on.

There were accusations here about the Hunt brothers in 1980 cornering the silver market. Mr. Masters will testify tomorrow, he and Mr. White did a report called *The Accidental Hunt Brothers,* which showed through the swaps, the deregulated swaps, the passive long investments went from $14 billion in 2004 to $313 billion long in the summer of 2008; and then $70 billion was taken out of that market immediately, which explains the drop. These markets were unregulated.

What Mr. Peterson is trying to do is bring them—we have heard a lot of great things about the CFTC here. That is great. Let's give the CFTC the power to see what is going on.

Mr. BOCCIERI. Let me try to suggest whether it is farmers, or oil companies, or car manufacturers, betting on the price of their product going up to me just seems like a total disconnect with respect to regulating the laws of the supply and demand.

Mr. GREENBERGER. President Roosevelt would have agreed with you, Congressman. Because, in 1934, he proposed the Commodity Exchange Act, which included speculation limits in it. That wasn't to bar speculation. It was to bar excessive speculation. The Act does bar excessive speculation.

What we did in 2000 with the Commodity Futures Modernization Act was take oil futures, agriculture futures, and swaps outside of the speculation limits to ban not speculation, which we need, but excessive speculation.

Mr. COTA. And the key component——

The CHAIRMAN [presiding.] I thank the gentleman.

The gentleman from Minnesota, Mr. Walz.

Mr. WALZ. Thank you, Mr. Chairman, and to our Ranking Member for holding this, as my colleagues have said, incredibly informative discussion.

I do want to thank each and every one of you. You are being very candid, very open; and that is very helpful to us.

Because, the bottom line is that we all want our markets to function correctly. We want to make sure that they are regulated to the point where people have trust in them, but that we are still encouraging innovation and people to move forward on some of these instruments.

So all of us are trying to understand this. I think in that spirit, because this is very complicated—and I do thank Chairman Peterson personally. He has for several years talked to me and tried to educate me on these.

What I would like to do, maybe Mr. Buis or Mr. Gooch, if you would help me, if each one of you would tell me—Mr. Buis, you can pick that soybean farmer out in Albert Lea, Minnesota, that is a Farmers Union member. Tell me how the future market works for them and how it affects their paycheck.

Then, Mr. Gooch, tell me what your brokers do and what the futures market does and how they collect their paycheck, and what role each of them has in securing the economic well-being of this country.

If you could do that, that would really help. Because I want to talk to my constituents about why this affects them. It is all too easy to demonize or take a populist position and point fingers. I want to get it right.

So, Tom, if you want to start.

Mr. BUIS. All right. Thank you, Congressman.

That farmer, that soybean farmer in Albert Lea, what this really means to them is their ability to price their product when they can get a decent return out of the marketplace. That doesn't occur after harvest, because you generally have a lot of product coming onto the market. So they look for opportunities at other times during the year, after harvest, on when they are going to deliver that product and get the best price.

When they are precluded from the marketplace, like this time, in many cases—my friend, Mr. Damgard, got $7¼ for his corn, but not everyone did—then they have to accept a price after harvest. If you look at all the spring crops this year, in Minnesota and elsewhere, they all collapsed before harvest; and so those producers were put at even a greater risk.

I would remind the Committee this is—the original derivative is farmers selling their products after harvest into the future, and that sound financial instrument was taken out of their hands this year.

Mr. WALZ. Mr. Gooch, if you could explain to me what does a broker at your firm do, and how do they look to the futures market in terms of how it affects the paycheck they are taking home?

Mr. GOOCH. Certainly. We operate a number of electronic marketplaces for both OTC and listed derivatives. And in the very cash end of the marketplace, in such things as government bonds and the most liquid instruments like foreign exchange and the most liquid equities, they lend themselves very well to pure electronic trading.

But when you move across the curve to further out, what we could be talking about, a 5 year Russian default swap or something like that, there is a need to have some interface amongst our brokers that work with the customers—and the customers tend to be large banks, large investment banks, some hedge funds—in helping them find the best execution, and finding the best counterparty to offset that transaction with.

Our brokers work in an environment which looks like a trading floor that you have probably seen at any investment house on TV, *et cetera*, *et cetera*. They communicate with their customers via e-mail, instant message, Bloomberg messaging, telephone, and also via our electronic trading platform; and they generate conditions for crossing trades. Those commissions, that is the fee we charge to our customers for generating the transaction; and then our brokers are typically paid a percentage of that fee that is generated. That is how they get paid their commission, once every 6 months or so, on the business that they produced on the trading desk.

Mr. WALZ. So for both of you—yes, go ahead, Mr. Damgard.

Mr. DAMGARD. I would just like to correct the record. I got a little over $7 for a little bit of my corn.

Mr. WALZ. Okay. Thank you.

Mr. DAMGARD. We didn't use the futures market. We went to a cooperative country elevator, and we sold that corn. When that country elevator ran out of credit from CoBank, he could no longer accept forward delivery.

Our alternative at that point—and I live fairly near the Illinois River—was to deliver directly to a delivery point, at which point my contract allows me to do that. But not a lot of farmers use the futures market in the sense that they actively trade. It is the elevator that utilizes the futures market in a way that he can offer the soybean farmer in Minnesota or Illinois a cash price.

Mr. WALZ. My final question, and I know I am right at the end of my time, is for some of the rest of you to explain this to me. I am still having trouble understanding why full transparency would be a bad thing. It is a very important point, and I believe they need it to work. I just don't understand why we don't want a clearing mechanism for these. Is it just unsustainable? Was that the argument that we heard, that in September they would have collapsed right along with everyone else?

Mr. GOOCH. I think everybody seems to be in favor of a clearing mechanism. I certainly have spoken in favor of a clearing mechanism. I haven't heard anybody here say that they are not in favor of a clearing mechanism and full transparency.

Mr. DUFFY. And, just to add on to that, you are seeing the major Wall Street firms agree that a clearing solution is definitely needed for the future of credit default swaps.

So I don't think anyone is opposing it. I think what some are saying in this room, and some are saying on Wall Street, that there is a certain type of products that may not lend itself for trading or clearing because of the illiquid nature that they represent. But the majority of the contracts, I think everybody's in agreement they do need to be cleared to avoid the systemic risk in the system.

Mr. DAMGARD. Estimates are that 75 percent of these contracts are standardized to the point where they could be cleared. But if they are too customized, or if the owners of the clearinghouse feel that the risk profile is such that they don't want to clear them— I mean, I represent the clearing members, and they are very interested in this business. They are interested in it in Mr. Duffy's exchange, which is an extremely well-run clearinghouse, but there are others as well, both in the United States and outside the United States, that are anxiously racing each other to see who can be there first in case they can be the one that does most of the——

Mr. WALZ. Thank you. Thank you for the time, Mr. Chairman.

The CHAIRMAN. I would just say if these things are too risky that nobody wants to clear them, they probably shouldn't be done in the first place. Okay?

The gentleman from Alabama, Mr. Bright.

Mr. BRIGHT. I have no questions.

The CHAIRMAN. All right.

Well, we have gone longer than we expected. Thank you very much.

Mr. CONAWAY. Mr. Chairman, I had one quick one. It has to do with these noncleared contracts. Could we get some sort of a sense of what the risks to the overall system are for having these two-party, very discrete, very unique contracts between two parties, do those then represent risks beyond just the two parties who entered into the contract? Can you help us understand what risks are there that aren't——

Mr. GREENBERGER. Congressman, I would say that that is why this exemption is so valuable, because they don't. When they are standardized and they are traded like this, that is when the risk is created. I think Mr. Marshall is on to something. If the exemption that Mr. Peterson has for the things that can't be cleared but are safe is put into effect, part of the safety should be the CFTC should make sure that both parties have adequate capital to deliver if they lose the transaction.

Mr. CONAWAY. Okay. Mr. Damgard or Mr. Duffy, you guys agree?

Mr. DAMGARD. I mean, I would say there are a lot of bilateral transactions out there that are relatively small. If you are going to buy a car and you put down a down payment, and it is going to be delivered 60 days from now, that shouldn't be something the CFTC worries about. That is the trust of the dealer and the purchaser. So, that there is some individual responsibility in any bilateral transaction to make sure that the other person——

Mr. CONAWAY. Yes, but we are not talking about cars. We are talking about something broad enough or big enough that would really threaten our markets that we should have cleared even though it was unique.

Mr. DUFFY. I believe, sir, that the risk can be—it is going to be minimized because of the fact that a high percentage of these credit default swaps will be able to be cleared on an exchange. Even the ones that are really toxic in nature—and I agree with Chairman Peterson, what he said, that maybe if they are too toxic they should be untradeable. We are coming up with pricing mechanisms to value those so we can go ahead and clear these products. So, it will be a small amount of outstanding credit default swaps. And, yes, there may be a couple that do go away.

Mr. CONAWAY. Okay. But, over time, you think the bulk of those unique ones would go away?

Mr. DUFFY. I think the bulk of them can be cleared almost to 100 percent.

Mr. CONAWAY. All right. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

Panel, thank you very much for being with us. It was very helpful, we apologize for keeping you so long, but the panel is excused.

We have one more panel with two members. We will try to move through this as expeditiously as we can.

Welcome the final panel for the day: Mr. Daniel Roth, President and CEO of the National Futures Association in Chicago; and Mr. Tyson Slocum, who is the Director of Public Citizen's Energy Program in Washington, DC.

We welcome you to the Committee.

Your statements will be made part of the record, and we encourage you to summarize your statements.

Mr. Roth, you are recognized for 5 minutes.

STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CEO, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

Mr. ROTH. Thank you, Mr. Chairman.

My name is Dan Roth, and I am the President of National Futures Association. I would like to thank you very much for the opportunity to be here today to discuss our views.

Certainly the draft bill that you have been discussing this afternoon couldn't be more timely. I think we all know that the current financial crisis has highlighted the importance of these issues. So I applaud you for your efforts to deal with these very complex issues.

We have some suggestions in our written testimony regarding some improvements that we think could be made to the bill, and we would be happy to discuss those. But one thing I want to talk about today, at risk of getting us off on a little bit of a tangent, and I certainly don't mean to do that. But, as important as the issues are that are covered by the bill, I hope we don't lose sight of an important customer protection issue that needs to be addressed and is somewhat overdue.

As we sit here today, we have to recognize that we have completely unregulated futures markets aimed expressly at unsophisticated retail customers. That is not a good situation to be in.

Through a series of bad cases, starting with the *Zelener* decision, we have had a series of decisions which essentially gutted the CFTC's ability, gutted the CFTC's jurisdiction with respect to bucket shops. Those contracts, those cases basically hold that certain contracts that may walk like a futures contract, talk like a futures contract, smell like a futures contract will be deemed by the courts not to be a futures contract if the scammer drafts the contract in a certain way, and therefore deprives the CFTC of jurisdiction.

Congress addressed this issue last May with respect to forex contracts—and God bless you for doing that—but, as we said at the time, the problem isn't limited to forex contracts and the solution can't be limited to that way, either.

We testified previously that if we only dealt with the forex aspect of this problem, then we would simply see a migration of problematic contracts from forex to other commodities; and that is exactly what we have seen. I don't have exact numbers, because, of course, these entities are unregistered, but just in our routine Internet surveillance and through customer complaints we are aware of dozens, dozens of these markets that are aimed exclusively at retail customers that are offering futures look-alike products for gold, silver, and energy.

For all these markets, there is no capital requirement. There is no registration requirement. There is no one doing audits and examinations. There is no sales practice rules. There is no arbitration. There is no nothing. These are completely unregulated markets, and they are taking advantage of retail customers.

We had a caller a couple weeks ago, a gentleman lost over $600,000 with one of these outfits. It was essentially all of his life savings.

I think it is safe, given the volume of the activity that we see, that there are thousands of customers who have lost millions of dollars through these types of unregistered, unregulated markets. It is not right, and the time has come to fix that problem.

We have a solution. It is a solution we have discussed before. It is a solution that we have worked on with the exchanges. Basically, what we have proposed in the past, and have proposed now, would be a statutory presumption that any market that offers a leveraged contract offered to retail customers, and that retail customer has no commercial use for this product and no ability or capacity to take delivery, that under those circumstances there would be a presumption that those were in fact futures contracts, and therefore had to be traded on-exchange.

This is simply nothing more than the codification of the *Co Petro* case, which the *Zelener* case overturned. That presumption would ensure that customers get the regulatory protections they deserve and need if trading in a regulated environment, and it is a change which is long overdue.

So, Mr. Chairman, I know there are other very important, very complex issues on the table. We have our opinions about some portions of the draft bill. We have included that. But I hope we don't lose sight of this important customer protection issue while you are dealing with this legislation.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Roth follows:]

PREPARED STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CEO, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

My name is Daniel Roth, and I am President and Chief Executive Officer of National Futures Association. Thank you, Chairman Peterson and Members of the Committee, for this opportunity to present our views on legislation to bring greater transparency and accountability to commodity markets.

NFA is the industry-wide self-regulatory organization for the U.S. futures industry. NFA is a not for profit organization, we do not operate any markets, we are not a trade association. Regulation and customer protection is all that we do.

NFA certainly understands the importance of responding to the current financial crisis, dealing with systemic risk and creating greater transparency in OTC markets. NFA would like to point out that as a result of bad case law, more and more retail customers are being victimized in off-exchange futures markets. This is a customer protection issue that needs to be addressed now.

Customer Protection

For years, unsophisticated, retail customers that invested in futures had all of the regulatory protections of the Commodity Exchange Act. Their trades were executed on transparent exchanges, their brokers had to meet the fitness standards set forth in the Act and their brokers were regulated by the CFTC and NFA. Today, for too many customers, none of those protections apply. A number of bad court decisions have created loopholes a mile wide and retail customers are on their own in unregulated, non-transparent OTC futures-type markets.

Congress acted to close those loopholes last May with respect to forex trading but customers trading other commodities, such as gold and silver, are still stuck in an unregulated mine field. It's time to restore regulatory protections to all retail customers.

Let me remind you how we got here. In the *Zelener* case, the CFTC attempted to close down a boiler room selling off-exchange forex trades to retail customers. The District Court found that retail customers had, in fact, been defrauded but that the CFTC had no jurisdiction because the contracts at issue were not futures, and the Seventh Circuit affirmed that decision. The "rolling spot" contracts in *Zelener* were marketed to retail customers for purposes of speculation; they were sold on margin; they were routinely rolled over and over and held for long periods of time; and they were regularly offset so that delivery rarely, if ever, occurred. In *Zelener*, though, the Seventh Circuit based its decision that these were not futures contracts exclusively on the terms of the written contract itself. Because the written contract in *Zelener* did not include a guaranteed right of offset, the Seventh Circuit ruled that the contracts at issue were not futures.

For a short period of time, *Zelener* was just a single case addressing this issue. Since 2004, however, various Courts have continued to follow the Seventh Circuit's approach in *Zelener*, which caused the CFTC to lose enforcement cases relating to forex fraud. Last year Congress plugged this loophole for forex contracts but not for other commodities.

Unfortunately, the rationale of the *Zelener* decision is not limited to foreign currency products. In testimony before this Subcommittee in 2007, I predicted that if Congress only addressed the forex aspect of the *Zelener* decision, the fraudsters would merely move their activities to other commodities. That's just what has happened. We cannot give you exact numbers, of course, because these firms are not registered. Nobody knows how widespread the fraud is, but we are aware of dozens of firms that offer *Zelener* contracts in metals or energy. Some of these firms are being run by individuals that we have kicked out of the futures industry for fraud. Several weeks ago, we received a call from a man who had lost over $600,000, substantially all of his savings, investing with one of these firms. We have seen a sharp increase in customer complaints in the last 3 months. It is safe to say that these unregulated bucket shops have plundered millions of dollars from retail customers.

NFA and the exchanges have previously proposed a fix to *Zelener* that goes beyond forex and does not have unintended consequences. Our approach codifies the approach the Ninth Circuit took in *CFTC* v. *Co Petro*—which was the accepted and workable state of the law until *Zelener*—without changing the jurisdictional exemption in section 2(c) of the Act. In particular, our approach would create a statutory presumption that leveraged or margined transactions offered to retail customers are futures contracts if the retail customer does not have a commercial use for the commodity or the ability to make or take delivery. This presumption is flexible and could be overcome by showing that the transactions were not primarily marketed to retail customers or were not marketed to those customers as a way to speculate on price movements in the underlying commodity.

This statutory presumption would effectively prohibit off-exchange contracts—other than forex—with retail customers when those contracts are used for price speculation. This is the cleanest solution and the one NFA prefers. If Congress is hesitant to ban these transactions, however, they should at least be regulated in the same manner as retail OTC forex futures contracts. (See section 2(c)(2)(B) of the Act.)

Commission Resources

NFA strongly supports the bill's effort to provide the Commission with much-needed resources. CFTC staffing levels are at historic lows. As trading volume rose over the years, staffing levels moved in the other direction. Something here is not right. It is always a struggle for a regulator to keep up with an ever changing market place, but that becomes harder and harder to do when you have fewer people on hand to do more work. NFA applauds proposals for emergency appropriations to the CFTC to hire additional people and upgrade its technology.

Position Limits

NFA is concerned with the proposal to impose position limits on futures contracts for excluded commodities. In 2000, Congress amended the Commodity Exchange Act to define certain commodities as "excluded commodities." These are primarily financial commodities, indices, and contingencies. By their very nature, excluded commodities are not susceptible to manipulation, either because there is such a large supply that it cannot be cornered or because, as with the contingencies, the contracts are based on events that are beyond anyone's control. Therefore, position limits in excluded commodities serve no purpose except to reduce the liquidity that helps banks and other institutions manage their risks. Furthermore, this reduced liquidity would come at a time when risk management is more critical than ever.

Credit Default Swaps

Section 16 of the draft bill is an even greater threat to liquidity. That section appears to restrict the use of credit default swaps to hedgers. NFA supports efforts to bring greater transparency to these transactions and to reduce their systemic risk. This proposed remedy, however, is likely to kill the patient. You cannot have an effective market if you do not have liquidity and you cannot have liquidity if you do not have speculators. Eliminating speculators from the credit default swap market will make it much more difficult for firms to manage their risks, which cannot be good for those firms or for the economy.

Mandatory Clearing of OTC Derivatives

Clearing organizations in the U.S. futures markets have performed superbly for over 100 years. The current financial crisis has posed the ultimate test to the clearing system—a test that was passed with the highest possible grades. Even under the greatest market stress we have seen for generations, no futures customers lost money due to an FCM insolvency and positions were transferred from distressed firms to healthy ones smoothly and efficiently. There has been no Federal bailout necessary for the futures industry. Clearing in the futures markets works and the spread of clearing to OTC markets can be a very positive development.

All OTC derivatives, however, are not like futures. It is the standardized nature of futures contracts and the ability to mark them to a liquid and transparent market that make clearing work so well. Many OTC instruments are quite standardized and susceptible to clearing. Others, though, are highly individualized and privately negotiated and difficult to mark to a market. The bill attempts to recognize these problems by providing the CFTC with exemptive authority. That authority, however, is circumscribed. I suspect it is impossible to draft legislation that can take into account all of the factors that might make it appropriate to exempt an OTC transaction from mandatory clearing. We would suggest that the bill give the CFTC greater flexibility to exercise its exemptive authority.

In conclusion, NFA's overriding concern with the bill is in what it does not contain. Retail customers trading in OTC metals and energies should not be left at the mercy of scammers. We encourage the Committee to revise the draft to prohibit—or at least regulate—*Zelener*-type contracts in commodities other than currencies.

As always, NFA looks forward to working with the Committee, and I would be happy to answer any questions.

The CHAIRMAN. Thank you very much. That is very much on point, and we will definitely take that into consideration. We have been so focused on this other stuff we kind of lose sight sometimes. So I appreciate your being with us.

Mr. Slocum?

Go ahead.

Mr. ROTH. No, I am just happy to be a nag about it, because it is an issue that is important to us.

The CHAIRMAN. Very much. Thank you.

The CHAIRMAN. Mr. Slocum?

STATEMENT OF TYSON SLOCUM, DIRECTOR, ENERGY PROGRAM, PUBLIC CITIZEN, WASHINGTON, D.C.

Mr. SLOCUM. I am Tyson Slocum. I direct the Energy Program at Public Citizen.

Public Citizen is one of America's largest consumer advocacy groups. We primarily get our funding from the 100,000 Americans across the country that pay dues to support our organization's work.

My particular area of focus is on energy policy, and we have heard from our members and from Americans all over the country about the incredibly harmful impacts the volatility in energy prices have had on working people across the country. There is no question that this volatility is the direct result of rampant speculation, speculation made possible due to unregulated or under-regulated energy futures markets. I think that it is not a coincidence that the speculative bubble burst in crude oil at the same time that the Wall Street credit crisis occurred. These speculators were speculating on highly leveraged bets; and once the credit seized up, their ability to continue speculating also evaporated. So the huge drop in prices from $147 a barrel in just 5 months to $40 a barrel was a direct result of the ability of the speculators to continue evaporating.

So the draft legislation that has been put together by Chairman Peterson does an excellent job as a first step to addressing the need to increase transparency and regulation over these futures markets. By bringing foreign exchanges under CFTC jurisdiction, by requiring mandatory clearing for OTC markets—although there is this big exemption that I am concerned about—requiring more detailed data from index traders and swaps dealers, requiring a review of all past CFTC decisions, which I believe undermined the transparency of the market, all of these are excellent things.

The need to re-regulate these markets is all the more important because of the enormous consolidation that we have seen among the speculators. In response to the Wall Street crash, there has been a number of mergers between entities that had significant energy trading portfolios. There were no hearings when any of these mergers were approved; and so you had a lot of these very powerful entities become even larger and more powerful, with little or no public scrutiny over the impacts on the future of energy trading markets. So improving transparency, as the draft Derivatives Markets Transparency and Accountability Act, is an excellent start.

There is an area that the legislation doesn't address that I would like to touch on for the rest of my opening statement. And that is dealing with what Public Citizen identifies as a serious matter of concern regarding the intersection of speculators like Wall Street investment banks and their ownership or control over physical energy infrastructure assets such as storage facilities, pipelines, oil refineries, and other physical energy infrastructure assets.

There has been an explosion just over the last couple of years of Wall Street investment banks taking over pipeline systems and other energy infrastructure with, I believe, the sole purpose to provide them with added ability to enhance their speculative activities in the futures market. It is the only reason that I could figure why a company like Goldman Sachs would acquire 40,000 miles of petroleum product pipeline in North America through its 2006 acquisition of Kinder Morgan. Owning pipelines is a relatively low return business. With pipeline operations, their profits are heavily regulated. But owning and controlling pipeline systems gives an investment bank that has a large speculative division an insider's peek into the movement of information, of product that enhances their ability to make large speculative trades.

The fact that Morgan Stanley, when I was reviewing their most recent annual report, boasted that they were going to be spending half a billion dollars in 2009 leasing petroleum storage facilities in the United States and, as Morgan Stanley said—I am quoting from their annual report—in connection with its commodities business, Morgan Stanley enters into operating leases for both crude oil and refined product storage for vessel charters. These operating leases are integral parts of the company's commodities risk management business.

Just a month ago, *Bloomberg* reported that investment banks and other financial firms had 80 million barrels of oil stored offshore in oil tankers that were not being shipped to deliver into markets, to deliver oil and other needed products to consumers, but simply to use them to enhance their speculative hedging tactics.

So, that it would be great if the Committee could examine a study by the CFTC or another appropriate entity to determine whether or not the intersection of ownership and control over physical energy assets with energy market speculative activities requires additional levels of scrutiny.

Thank you very much for your time, and I look forward to your questions.

[The prepared statement of Mr. Slocum follows:]

PREPARED STATEMENT OF TYSON SLOCUM, DIRECTOR, ENERGY PROGRAM, PUBLIC CITIZEN, WASHINGTON, D.C.

Protecting Families From Another Energy Price Shock: Restoring Transparency and Regulation to Futures Markets To Keep the Speculators Honest

Thank you, Mr. Chairman and Members of Committee on Agriculture for the opportunity to testify on the issue of energy futures regulation. My name is Tyson Slocum and I am Director of Public Citizen's Energy Program. Public Citizen is a 38 year old public interest organization with over 100,000 members nationwide. We represent the needs of households by promoting affordable, reliable and clean energy.

The extraordinary volatility in energy prices, particularly crude oil—which soared from $27/barrel in September 2003 to a high of $147/barrel in July 2008 before plummeting to its current price of $40/barrel—wreaked havoc with the economy while making speculators rich. The spectacular 75% decline in oil prices in just 5 months cannot be explained purely by supply and demand; rather, a speculative bubble burst, triggered by the Wall Street financial crisis. Strapped of their credit that had been fueling their highly leveraged trading operations, the credit crisis ended the speculators' ability to continue driving up prices far beyond the supply demand fundamentals. This speculation was made possible by legislative and regulatory actions that deregulated these energy futures markets. Although energy prices are no longer at record highs, it must be assumed that it is a matter of when, not if, a return to high prices will occur. Absent reregulation of the energy futures markets, aggressive government efforts to restore liquidity and unfreeze the credit markets will give new life to the Wall Street financial speculators, ushering a return to an energy commodity speculative bubble.

Restoring transparency to futures markets is all the more urgent given the wave of consolidation that has occurred among the financial firms that were leading the speculative frenzy. Several major energy trading firms merged their operations in response the credit crisis:

- In 2007, ABN Amro was purchased by the Dutch National Government, the Royal Bank of Scotland and Spain's Banco Santander.
- In April 2008, J.P.Morgan Chase acquired Bear Stearns and its trading operations.
- In September 2008, Bank of America acquired Merrill Lynch.
- In October 2008, Wells Fargo and Wachovia agreed to merge.
- Électricité de France arranged to purchase all of Lehman Bros. energy trading operations in October 2008.
- Wells Fargo agreed to buy Wachovia in October 2008.
- In January 2009, UBS sold its energy trading operations to Barclays.

Congress can take two broad actions to provide relief: providing incentives to households to give them better access to alternatives to our dependence on oil, and restoring transparency to the futures markets where energy prices are set. The former option is of course an effective long-term investment, as providing incentives to help families afford the purchase of super fuel efficient hybrid or alternative fuel vehicles, solar panel installation, energy efficient improvements to the home and greater access to mass transit would all empower households to avoid the brunt of high energy prices.

The second option-restoring transparency to the futures markets where energy prices are actually set—is equally important. Stronger regulations over energy trading markets would reduce the level of speculation and limit the ability of commodity traders to engage in anti-competitive behavior that is contributing the record high prices Americans face. And as Congress considers market-based climate change legislation that would create a pollution futures trading market, the priority of establishing strong regulatory oversight over all energy- and pollution-related futures trading is the only way to effectively combat climate change, in order to ensure price transparency.

Of course, supply and demand played a role in the recent rise and decline in oil prices. Gasoline demand in America is down, with Americans driving 112 *billion* less miles from November 2007 to November 2008,[1] and global demand—even in emerging economies like China, India and oil exporting nations in the Middle East—has slackened in response to the global economic downturn, thereby offsetting the fact that mature, productive and easily-accessible oil fields are in decline. Claims of Saudi spare capacity are questioned due to the Kingdom's refusal to allow independent verification of the country's oil reserve claims. Simply put, oil is a finite resource with which the world—until recently—has embarked on unprecedented increased demand.

But there is no question that speculators and unregulated energy traders have pushed prices beyond the supply-demand fundamentals and into an era of a speculative bubble in oil markets. While some speculation plays a legitimate function for hedging and providing liquidity to the market, the exponential rise in market participants who have no physical delivery commitments has skyrocketed, from 37 percent of the open interest on the NYMEX West Texas Intermediate (WTI) contract in January 2000 to 71 percent in April 2008.[2]

Rather than demonize speculation generally, the goal is to address problems associated with recent Congressional and regulatory actions that deregulated energy trading markets that has opened the door to these harmful levels of speculation. Removing regulations has opened the door too wide for speculators and powerful financial interests to engage in anti-competitive or harmful speculative behavior that results in prices being higher than they would otherwise be. When oil was at $145/barrel, many estimated that at least $30 of that price was pure speculation, unrelated to supply and demand.

While the Commodity Futures Trading Commission (CFTC) and Congress have taken recent small steps in the right direction, more must be done to protect consumers. While the CFTC has been disparaged by consumer advocates as being too deferential to energy traders, it has responded to recent criticism by ordering the United Kingdom to set limits on speculative trading of WTI contracts, proposing stronger disclosure for index traders and swap dealers, spearheading an interagency task force to more closely monitor energy markets and strengthening disclosure requirements in its amended Dubai Mercantile Exchange No Action letter. But these actions are hardly enough to rein in the harmful levels of speculation and anti-competitive behavior that are causing energy prices to rise. A new CFTC Chairman presents important opportunities for the agency to take a more assertive role in policing these markets.

Recent Congressional action, too, has been beneficial to consumers, but the legislation has not gone nearly far enough. Title XIII of H.R. 6124 (the "farm bill") that became law in June 2008, closed some elements of the so-called "Enron Loophole," which provided broad exemptions from oversight for electronic exchanges like ICE. But the farm bill only provides limited protections from market manipulation, as it allows the CFTC, "at its discretion," to decide on a contract-by-contract basis that an individual energy contract should be regulated only if the CFTC can prove that the contract will "serve a significant price discovery function" in order to stop anti-competitive behavior.

In December 2007, H.R. 6 was signed into law. Sections 811 through 815 of that act empower the Federal Trade Commission to develop rules to crack down on petroleum market manipulation.[3] If these rules are promulgated effectively, this could prove to be an important first step in addressing certain anti-competitive practices in the industry.

Public Citizen recommends four broad reforms to rein in speculators and help ensure that energy traders do not engage in anti-competitive behavior:

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[1] *www.fhwa.dot.gov/ohim/tvtw/tvtpage.htm.*

[2] *http://energycommerce.house.gov/Investigations/EnergySpeculationBinder__062308/15.pdf.*

[3] *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110__cong__public__laws&docid=f:publ140.110.pdf.*

- Subject over-the counter (OTC) trading to the same transparency and regulatory requirements to which regulated exchanges, such as NYMEX, must adhere, including the submission of Large Trader Reports which disclose key information of a trader's activities. Requiring investment banks, hedge funds and other market participants to provide more information to the government will provide regulators and policymakers with the data necessary to quickly determine the exact cause of price swings.
- Raise margin requirements so market participants will have to put up more of their own capital in order to trade energy contracts, and impose aggregate position limits on non-commercial trading to reduce speculation. Currently, margin requirements are too low, which encourages speculators to more easily enter the market by borrowing, or leveraging, against their positions. And aggregated limits over all markets—not just select ones—would preclude an energy trader from dipping their hands in multiple futures market cookie jars with the intent to speculate.

Who Are the Speculators?

While everyone talks about speculators, rarely are names named. Following are some of the largest financial players in commodity markets that largely hold financial positions, and the trade groups that help promote their deregulation agenda:

ABN Amro • Bank of America/Merrill Lynch •Barclays Capital • Citadel Investment Group • Citigroup • Crédit Agricole • Credit Suisse • D.E. Shaw • Deutsche Bank • Électricité de France • IntercontinentalExchange • International Swaps & Derivative Assn • Goldman Sachs • HSBC • J.P.Morgan Chase-Bear Stearns • Man Financial • Managed Funds Assn • Morgan Stanley • Prudential Global Funding • Securities Industry & Financial Markets Assn. • Vitol • Wells Fargo-Wachovia

- Require foreign-based exchanges that trade U.S. energy products to be subjected to full U.S. regulatory oversight.
- Impose legally-binding firewalls to limit energy traders from speculating on information gleaned from the company's energy infrastructure affiliates or other such insider information, while at the same time allowing legitimate hedging operations. Congress must authorize the FTC and DOJ to place greater emphasis on evaluating anti-competitive practices that arise out of the nexus between control over hard assets like energy infrastructure and a firm's energy trading operations.

Legislation introduced by U.S. Representative Collin C. Peterson, "The Derivatives Markets Transparency and Accountability Act of 2009,"[4] does a great job addressing most of Public Citizen's recommendations. There are two areas, however, upon which the legislation could be improved. First, the bill should immediately subject OTC markets to the same regulatory oversight to which regulated exchanges like NYMEX must adhere. Second, the legislation should impose aggregate speculation limits over all markets to limit the ability of traders to engage in harmful speculation.

Energy Trading Abuses Require Stronger Oversight

Background

Two regulatory lapses are enabling anti-competitive practices in energy trading markets where prices of energy are set. First, oil companies, investment banks and hedge funds are exploiting recently deregulated energy trading markets to manipulate energy prices. Second, energy traders are speculating on information gleaned from their own company's energy infrastructure affiliates, a type of legal "insider trading." These regulatory loopholes were born of inappropriate contacts between public officials and powerful energy companies and have resulted in more volatile and higher prices for consumers.

Contrary to some public opinion, oil prices are not set by the Organization of Petroleum Exporting Countries (OPEC); rather, they are determined by the actions of energy traders in markets. Historically, most crude oil has been purchased through either fixed-term contracts or on the "spot" market. There have been long-standing futures markets for crude oil, led by the New York Mercantile Exchange and London's International Petroleum Exchange (which was acquired in 2001 by an Atlanta-based unregulated electronic exchange, ICE). NYMEX is a floor exchange regulated by the U.S. Commodity Futures Trading Commission (CFTC). The futures market has historically served to hedge risks against price volatility and for price discovery. Only a tiny fraction of futures trades result in the physical delivery of crude oil.

The CFTC enforces the Commodity Exchange Act, which gives the Commission authority to investigate and prosecute market manipulation.[5] But after a series of deregulation moves by the CFTC and Congress, the futures markets have been increasingly driven by the unregulated over-the-counter (OTC) market over the last few years. These OTC and electronic markets (like ICE) have been serving more as pure speculative markets, rather than traditional volatility hedging or price discovery. And, importantly, this new speculative activity is occurring outside the regulatory jurisdiction of the CFTC.

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[4] *http://agriculture.house.gov/inside/Legislation/111/PETEMN_001_xml.pdf.*
[5] 7 U.S.C. §§ 9, 13b and 13(a)(2).

Energy trading markets were deregulated in two steps. First, in response to a petition by nine energy and financial companies, led by Enron,[6] on November 16, 1992, then-CFTC Chairwoman Wendy Gramm supported a rule change—later known as Rule 35—exempting certain energy trading contracts from the requirement that they be traded on a regulated exchange like NYMEX, thereby allowing companies like Enron and Goldman Sachs to begin trading energy futures between themselves outside regulated exchanges. Importantly, the new rule also exempted energy contracts from the anti-fraud provisions of the Commodity Exchange Act.[7] At the same time, Gramm initiated a proposed order granting a similar exemption to large commercial participants in various energy contracts that was later approved in April 2003.[8]

Enron had close ties to Wendy Gramm's husband, then-Texas Senator Phil Gramm. Of the nine companies writing letters of support for the rule change, Enron made by far the largest contributions to Phil Gramm's campaign fund at that time, giving $34,100.[9]

Wendy Gramm's decision was controversial. Then-Chairman of a House Agriculture Subcommittee with jurisdiction over the CFTC, Rep. Glen English, protested that Wendy Gramm's action prevented the CFTC from intervening in basic energy futures contracts disputes, even in cases of fraud, noting that that "in my 18 years in Congress [Gramm's motion to deregulate] is the most irresponsible decision I have come across." Sheila Bair, the CFTC Commissioner casting the lone dissenting vote, argued that deregulation of energy futures contracts "sets a dangerous precedent."[10] A U.S. General Accounting Office report issued a year later urged Congress to increase regulatory oversight over derivative contracts,[11] and a Congressional inquiry found that CFTC staff analysts and economists believed Gramm's hasty move prevented adequate policy review.[12]

Five weeks after pushing through the "Enron loophole," Wendy Gramm was asked by Kenneth Lay to serve on Enron's Board of Directors. When asked to comment about Gramm's nearly immediate retention by Enron, Lay called it "convoluted" to question the propriety of naming her to the Board.[13]

Congress followed Wendy Gramm's lead in deregulating energy trading *contracts* and moved to deregulate energy trading *exchanges* by exempting electronic exchanges, like those quickly set up by Enron, from regulatory oversight (as opposed to a traditional trading floor like NYMEX that remained regulated). Congress took this action during last-minute legislative maneuvering on behalf of Enron by former Texas GOP Senator Phil Gramm in the lame-duck Congress 2 days after the Supreme Court ruled in *Bush* v. *Gore,* buried in 712 pages of unrelated legislation.[14] As Public Citizen pointed out back in 2001,[15] this law deregulated OTC derivatives energy trading by "exempting" them from the Commodity Exchange Act, removing anti-fraud and anti-manipulation regulation over these derivatives markets and exempting "electronic" exchanges from CFTC regulatory oversight.

This deregulation law was passed against the explicit recommendations of a multi-agency review of derivatives markets. The November 1999 release of a report by the President's Working Group on Financial Markets—a multi-agency policy group with permanent standing composed at the time of Lawrence Summers, Secretary of the Treasury; Alan Greenspan, Chairman of the Federal Reserve; Arthur Levitt, Chairman of the Securities and Exchange Commission; and William Rainer, Chairman of the CFTC—concluded that energy trading must not be deregulated. The Group reasoned that "due to the characteristics of markets for nonfinancial commodities with finite supplies . . . the Working Group is unanimously recommending that the [regulatory] exclusion not be extended to agreements involving

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[6] The other eight companies were: BP, Coastal Corp. (now El Paso Corp.) Conoco and Phillips (now ConocoPhillips), Goldman Sachs' J. Aron & Co., Koch Industries, Mobil (now ExxonMobil) and Phibro Energy (now a subsidiary of CitiGroup).

[7] 17 CFR Ch. 1, available at *www.access.gpo.gov/nara/cfr/waisidx_06/17cfr35_06.html.*

[8] "Exemption for Certain Contracts Involving Energy Products," 58 *Fed. Reg.* 6250 (1993).

[9] Charles Lewis, "The Buying of the President 1996," pg. 153. The Center for Public Integrity.

[10] "Derivatives Trading Forward-Contract Fraud Exemption May be Reversed," *Inside FERC's Gas Market Report,* May 7, 1993.

[11] "Financial Derivatives: Actions Needed to Protect the Financial System," GGD–94–133, May 18, 1994, available at *http://archive.gao.gov/t2pbat3/151647.pdf.*

[12] Brent Walth and Jim Barnett, "A Web of Influence," *Portland Oregonian,* December 8, 1996.

[13] Jerry Knight, "Energy Firm Finds Ally, Director, in CFTC Ex-Chief," *Washington Post,* April 17, 1993.

[14] H.R. 5660, an amendment to H.R. 4577, which became Appendix E of P.L. 106–554 available at *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=106_cong_public_laws&docid=f:publ554.106.pdf.*

[15] *Blind Faith: How Deregulation and Enron's Influence Over Government Looted Billions from Americans,* available at *www.citizen.org/documents/Blind_Faith.pdf.*

such commodities."[16] In its 1999 lobbying disclosure form, Enron indicated that the "President's Working Group" was among its lobbying targets.[17]

As a result of the Commodity Futures Modernization Act, trading in lightly-regulated exchanges like NYMEX is declining as more capital flees to the unregulated OTC markets and electronic exchanges such as those run by the IntercontinentalExchange (ICE). Trading on the ICE has skyrocketed, with the 138 million contracts traded in 2007 representing a 230 percent increase from 2005.[18] This explosion in unregulated and under regulated trading volume means that more trading is done behind closed doors out of reach of Federal regulators, increasing the chances of oil companies and financial firms to engage in anti-competitive practices. The founding members of ICE include Goldman Sachs, BP, Shell and TotalfinaElf. In November 2005, ICE became a publicly traded corporation.

The Players

Goldman Sachs' trading unit, J. Aron, is one of the largest and most powerful energy traders in the United States, and commodities trading represents a significant source of revenue for the company. Goldman Sachs' most recent 10–k filed with the U.S. Securities and Exchange Commission show that Fixed Income, Currency and Commodities (which includes energy trading) generated 17 percent of Goldman's $22 billion in revenue for 2008.[19] That share, however, masks the role that energy trading plays in Goldman's revenue as the company lumps under-performing activities such as securitized mortgage debt, thereby dragging down revenues for the entire segment. Indeed, Goldman touted the performance of its commodity trading activities in 2008, noting that it "produced particularly strong results and net revenues were higher compared with 2007."

In 2005, Goldman Sachs and Morgan Stanley—the two companies are widely regarded as the largest energy traders in America—each reportedly earned about $1.5 billion in net revenue from energy trading. One of Goldman's star energy traders, John Bertuzzi, made as much as $20 million in 2005.[20]

In the summer of 2006, Goldman Sachs, which at the time operated the largest commodity index, GSCI, announced it was radically changing the index's weighting of gasoline futures, selling about $6 billion worth. As a direct result of this weighting change, Goldman Sachs unilaterally caused gasoline futures prices to fall nearly 10 percent.[21]

Morgan Stanley held $18.7 billion in assets in commodity forwards, options and swaps at November 30, 2008. As the company noted in its annual report: "Fiscal 2008 results reflected . . . record revenues from commodities . . . Commodity revenues increased 62%, primarily due to higher revenues from oil liquids and electricity and natural gas products."

A deregulation action by the Federal Reserve in 2003—at the request of Citigroup and UBS—allows commercial banks to engage in energy commodity trading.[22] Since then commercial banks have become big players in the speculation market. The total value of commodity derivative contracts held by the Citigroup's Phibro trading division increased 384 percent from 2004 through 2008, rising from $44.4 billion to $214.5 billion.[23] Bank of America held $58.6 billion worth of commodity derivatives contracts as of September 2008.[24] Merrill Lynch, which BoA acquired in September 2008, experienced "strong net revenues for the [third] quarter [2008] generated from our . . . commodities businesses."[25]

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[16] "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," Report of The President's Working Group on Financial Markets, pg. 16. *www.ustreas.gov/press/releases/docs/otcact.pdf.*

[17] Senate Office of Public Records Lobbying Disclosure Database, available at *http://sopr.senate.gov/cgi-win/opr__gifviewer.exe?/1999/01/000/309/000309331|30,* page 7.

[18] Available at *www.theice.com/exchange__volumes__2005.jhtml.*

[19] *http://idea.sec.gov/Archives/edgar/data/886982/000095012309001278/y74032e10vk.htm.*

[20] *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109__cong__senate__committee—prints&docid=f:28640.pdf,* pages 24 and 26.

[21] Heather Timmons, "Change in Goldman Index Played Role in Gasoline Price Drop," *The New York Times,* September 30, 2006.

[22] Regulation Y; Docket No. R–1146, *www.federalreserve.gov/boarddocs/press/bcreg/2003/20030630/attachment.pdf.*

[23] *http://idea.sec.gov/Archives/edgar/data/831001/000104746908011506/a2188770z10-q.htm.*

[24] *http://idea.sec.gov/Archives/edgar/data/70858/000119312508228086/d10q.htm.*

[25] *http://idea.sec.gov/Archives/edgar/data/65100/000095012308014369/y72170e10vq.htm.*

Just a year after Enron's collapse, the Commodity Futures Trading Commission finalized rules allowing hedge funds to engage in energy trading without registering with the CFTC, opening the door to firms like Citadel and D.E. Shaw.[26]

The Consequences of Deregulation

A recent bipartisan U.S. Senate investigation summed up the negative impacts on oil prices with this shift towards unregulated energy trading speculation:

> *Over the last few years, large financial institutions, hedge funds, pension funds, and other investment funds have been pouring billions of dollars into the energy commodity markets—perhaps as much as $60 billion in the* ***regulated*** *U.S. oil futures market alone . . . The large purchases of crude oil futures contracts by speculators have, in effect, created an additional demand for oil, driving up the price of oil to be delivered in the future in the same manner that additional demand for the immediate delivery of a physical barrel of oil drives up the price on the spot market . . . Several analysts have estimated that speculative purchases of oil futures have added as much as $20–$25 per barrel to the current price of crude oil . . . large speculative buying or selling of futures contracts can distort the market signals regarding supply and demand in the physical market or lead to excessive price volatility, either of which can cause a cascade of consequences detrimental to the overall economy . . . At the same time that there has been a huge influx of speculative dollars in energy commodities, the CFTC's ability to monitor the nature, extent, and effect of this speculation has been diminishing. Most significantly, there has been an explosion of trading of U.S. energy commodities on exchanges that are not regulated by the CFTC . . . in contrast to trades conducted on the NYMEX, traders on unregulated OTC electronic exchanges are not required to keep records or file Large Trader Reports with the CFTC, and these trades are exempt from routine CFTC oversights. In contrast to trades conducted on regulated futures exchanges, there is no limit on the number of contracts a speculator may hold on an unregulated OTC electronic exchange, no monitoring of trading by the exchange itself, and no reporting of the amount of outstanding contracts ("open interest") at the end of each day.*[27]

Thanks to the Commodity Futures Modernization Act, participants in these newly-deregulated energy trading markets are not required to file so-called Large Trader Reports, the records of all trades that NYMEX traders are required to report to the CFTC, along with daily price and volume information. These Large Trader Reports, together with the price and volume data, are the primary tools of the CFTC's regulatory regime: "The Commission's Large Trader information system is one of the cornerstones of our surveillance program and enables detection of concentrated and coordinated positions that might be used by one or more traders to attempt manipulation."[28] So the deregulation of OTC markets, by allowing traders to escape such basic information reporting, leave Federal regulators with no tools to routinely determine whether market manipulation is occurring in energy trading markets.

One result of the lack of transparency is the fact that even some traders don't know what's going on. A recent article described how:

> *Oil markets were rocked by a massive, almost instant surge in after-hours electronic trading one day last month, when prices for closely watched futures contracts jumped 8% . . . this spike stands out because it was unclear at the time what drove it. Two weeks later, it is still unclear. What is clear is that a rapid shift in the bulk of crude trading from the raucous trading floor of the New York Mercantile Exchange to anonymous computer screens is making it harder to nail down the cause of price moves . . . The initial jump "triggered more orders already set into the system, and with prices rising, people thought somebody must know something," Tom Bentz, an analyst and broker at BNP Paribas Futures*

[26] 17 CFR Part 4, RIN 3038–AB97, "Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors," final rule issued August 1, 2003.

[27] *The Role Of Market Speculation In Rising Oil And Gas Prices: A Need To Put The Cop Back On The Beat,* Staff Report prepared by the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs of the U.S. Senate, June 27, 2006, available at *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf.*

[28] Letter from Reuben Jeffrey III, Chairman, CFTC, to Michigan Governor Jennifer Granholm, August 22, 2005.

in New York who was watching the screen at the time, said the day after the spike. "The more prices rose, the more it seemed somebody knew something."[29]

Oil companies, investment banks and hedge funds are exploiting the lack of government oversight to price-gouge consumers and make billions of dollars in profits. These energy traders boast how they're price-gouging Americans, as a recent Dow Jones article makes clear: energy "traders who profited enormously on the supply crunch following Hurricane Katrina cashed out of the market ahead of the long weekend. 'There are traders who made so much money this week, they won't have to punch another ticket for the rest of this year,' said Addison Armstrong, manager of exchange-traded markets for TFS Energy Futures."[30]

The ability of Federal regulators to investigate market manipulation allegations even on the lightly-regulated exchanges like NYMEX is difficult, let alone the unregulated OTC market. For example, as of August 2006, the Department of Justice is still investigating allegations of gasoline futures manipulation that occurred *on a single day in 2002.*[31] If it takes the DOJ 4 years to investigate a single day's worth of market manipulation, clearly energy traders intent on price-gouging the public don't have much to fear.

That said, there have been some settlements for manipulation by large oil companies. In January 2006, the CFTC issued a civil penalty against Shell Oil for "noncompetitive transactions" in U.S. crude oil futures markets.[32] In March 2005, a Shell subsidiary agreed to pay $4 million to settle allegations it provided false information during a Federal investigation into market manipulation.[33] In August 2004, a Shell Oil subsidiary agreed to pay $7.8 million to settle allegations of energy market manipulation.[34] In July 2004, Shell agreed to pay $30 million to settle allegations it manipulated natural gas prices.[35] In October 2007, BP agreed to pay $303 million to settle allegations the company manipulated the propane market.[36] In September 2003, BP agreed to pay NYMEX $2.5 million to settle allegations the company engaged in improper crude oil trading, and in July 2003, BP agreed to pay $3 million to settle allegations it manipulated energy markets.[37]

In August 2007, Oil giant BP admitted in a filing to the Securities and Exchange Commission that "The U.S. Commodity Futures Trading Commission and the U.S. Department of Justice are currently investigating various aspects of BP's commodity trading activities, including crude oil trading and storage activities, in the U.S. since 1999, and have made various formal and informal requests for information."[38]

In August 2007, Marathon Oil agreed to pay $1 million to settle allegations the company manipulated the price of West Texas Intermediate crude oil.[39]

There is near-unanimous agreement among industry analysts that speculation is driving up oil and natural gas prices. Representative of these analyses is a May 2006 Citigroup report on the monthly average value of speculative positions in American commodity markets, which found that the value of speculative positions in oil and natural gas stood at $60 billion, forcing Citigroup to conclude that "we believe the hike in speculative positions has been a key driver for the latest surge in commodity prices."[40]

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[29] Matt Chambers, "Rise in Electronic Trading Adds Uncertainty to Oil," *The Wall Street Journal,* April 10, 2007.

[30] Leah McGrath Goodman, "Oil Futures, Gasoline In NY End Sharply Lower," September 2, 2005.

[31] John R. Wilke, Ann Davis and Chip Cummins, "BP Woes Deepen with New Probe," *The Wall Street Journal,* August 29, 2006.

[32] "U.S. Commodity Futures Trading Commission Assesses Penalties of $300,000 Against Shell-Related Companies and Trader in Settling Charges of Prearranging Crude Oil Trades" available at *www.cftc.gov/newsroom/enforcementpressreleases/2006/pr5150-06.html.*

[33] "Commission Accepts Settlement Resolving Investigation Of Coral Energy Resources," available at *www.ferc.gov/news/news-releases/2005/2005-1/03-03-05.asp.*

[34] "Order Approving Contested Settlement," available at *www.ferc.gov/whats-new/comm-meet/072804/E-60.pdf.*

[35] "Coral Energy Pays $30 Million to Settle U.S. Commodity Futures Trading Commission Charges of Attempted Manipulation and False Reporting," available at *www.cftc.gov/opa/enf04/opa4964-04.htm.*

[36] *www.cftc.gov/newsroom/enforcementpressreleases/2007/pr5405-07.html.*

[37] "Order Approving Stipulation and Consent Agreement," 104 FERC ¶61,089, available at *http://elibrary.ferc.gov/idmws/common/opennat.asp?fileID=10414789.*

[38] *www.sec.gov/Archives/edgar/data/313807/000115697307001223/u53342-6k.htm.*

[39] *www.cftc.gov/newsroom/enforcementpressreleases/2007/pr5366-07.html.*

[40] *The Role Of Market Speculation In Rising Oil And Gas Prices: A Need To Put The Cop Back On The Beat,* Staff Report prepared by the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs of the U.S. Senate, June 27, 2006,

Continued

Natural gas markets are also victimized by these unregulated trading markets. Public Citizen has testified before Congress on this issue,[41] and a March 2006 report by four State Attorneys General concludes that "natural gas commodity markets have exhibited erratic behavior and a massive increase in trading that contributes to both volatility and the upward trend in prices."[42]

The Industrial Energy Consumers of America wrote a January 2005 letter to the Securities and Exchange Commission "alarmed at the significant increase in unregulated hedge funds trading on the NYMEX and OTC natural-gas markets."[43] In November 2004 the group wrote Congress, asking them to "increase energy market oversight by the Commodity Futures Trading Commission."[44]

While most industry analysts agree that the rise in speculation is fueling higher prices, there is one notable outlier: the Federal Government. In a widely dismissed report, the CFTC recently concluded that there was "no evidence of a link between price changes and MMT [managed money trader] positions" in the natural gas markets and "a significantly negative relationship between MMT positions and prices changes . . . in the crude oil market."[45]

The CFTC study (and similar one performed by NYMEX) is flawed for numerous reasons, including the fact that the role of hedge funds and other speculators on long-term trading was not included in the analysis. *The New York Times* reported that "many traders have scoffed at the studies, saying that they focused only on certain months, missing price run-ups."[46]

Latest Trading Trick: Energy Infrastructure Affiliate Abuses

Energy traders like Goldman Sachs are investing and acquiring energy infrastructure assets because controlling pipelines and storage facilities affords their energy trading affiliates an "insider's peek" into the physical movements of energy products unavailable to other energy traders. Armed with this non-public data, a company like Goldman Sachs most certainly will open lines of communication between the affiliates operating pipelines and the affiliates making large bets on energy futures markets. Without strong firewalls prohibiting such communications, consumers would be susceptible to price-gouging by energy trading affiliates.

For example, In January 2007, Highbridge Capital Management, a hedge fund controlled by J.P.Morgan Chase, bought a stake in an energy unit of Louis Dreyfus Group to expand its oil and natural gas trading. Glenn Dubin, co-founder of Highbridge, said that owning physical energy assets like pipelines and storage facilities was crucial to investing in the business: "That gives you a very important information advantage. You're not just screen-trading financial products."[47]

Indeed, such an "information advantage" played a key role in allowing BP's energy traders to manipulate the entire U.S. propane market. In October 2007, the company paid $303 million to settle allegations that the company's energy trading affiliate used the company's huge control over transportation and storage to allow the energy trading affiliate to exploit information about energy moving through BP's infrastructure to manipulate the market.

BP's energy trading division, North America Gas & Power (NAGP), was actively communicating with the company's Natural Gas Liquids Business Unit (NGLBU), which handled the physical production, pipeline transportation and retail sales of propane. A PowerPoint exhibit to the civil complaint against BP details how the two divisions coordinated their manipulation strategy, which includes "assurance that [the] trading team has access to all information and optionality within [all of BP] . . . that can be used to increase chance of success [of market manipula tion] . . . Implement weekly meetings with Marketing & Logistics to review trading positions and share opportunities."[48]

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available at *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf.*

[41] "The Need for Stronger Regulation of U.S. Natural Gas Markets," available at *www.citizen.org/documents/Natural%20Gas%20Testimony.pdf.*

[42] *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral,* available at *www.ago.mo.gov/pdf/NaturalGasReport.pdf.*

[43] *www.ieca-us.com/downloads/natgas/SECletter013105.doc.*

[44] *www.ieca-us.com/downloads/natgas/111704LettertoCongr%23AAC2.doc.*

[45] Michael S. Haigh, Jana Hranaiova and James A. Overdahl, "Price Dynamics, Price Discovery and Large Futures Trader Interactions in the Energy Complex," available at *www.cftc.gov/files/opa/press05/opacftc-managed-money-trader-study.pdf.*

[46] Alexei Barrionuevo and Simon Romero, "Energy Trading, Without a Certain 'E'," January 15, 2006.

[47] Saijel Kishan and Jenny Strasburg, "Highbridge Capital Buys Stake in Louis Dreyfus Unit," *Bloomberg*, January 8, 2007, *www.bloomberg.com/apps/news?pid=20601014&sid=aBnQy1botdFo.*

[48] *www.cftc.gov/files/enf/06orders/opa-bp-lessons-learned.pdf.*

And in August 2007, BP acknowledged that the Federal Government was investigating similar gaming techniques in the crude oil markets.

BP is not alone. A Morgan Stanley energy trader, Olav Refvik, "a key part of one of the most profitable energy-trading operations in the world . . . helped the bank dominate the heating oil market by locking up New Jersey storage tank farms adjacent to New York Harbor."[49] As of November 2008, Morgan Stanley committed $452 million to lease petroleum storage facilities for 2009. As the company notes: "In connection with its commodities business, the Company enters into operating leases for both crude oil and refined products storage and for vessel charters. These operating leases are integral parts of the Company's commodities risk management business."[50] In 2003, Morgan Stanley teamed up with Apache Corp. to buy 26 oil and gas fields from Shell for $500 million, of which Morgan Stanley put up $300 million in exchange for a portion of the production over the next 4 years, which it used to supplement its energy trading desk.[51] Again, control over physical infrastructure assets plays a key role in helping energy traders game the market.

The Wall Street Journal suggested that the bankruptcy of a single firm, SemGroup, served as the initial trigger of crude oil's price collapse this summer. The company operated 1,200 miles of oil pipelines and held 15 million barrels of crude storage capacity, but was misleading regulators and its own investors on the extent of its hedging practices. Data suggests that SemGroup was taking out positions far in excess of its physical delivery commitments, becoming a pure speculator. When its bets turned sour, the company was forced to declare bankruptcy.[52]

This shows that the energy traders were actively engaging the physical infrastructure affiliates in an effort to glean information helpful for market manipulation strategies. And it is important to note that BP's market manipulation strategy was extremely aggressive and blatant, and regulators were tipped off to it by an internal whistleblower. A more subtle manipulation effort could easily evade detection by Federal regulators, making it all the more important to establish firewalls between energy assets affiliates and energy trading affiliates to prevent any undue communication between the units.

Financial firms like hedge funds and investment banks that normally wouldn't bother purchasing low-profit investments like oil and gasoline storage have been snapping up ownership and/or leasing rights to these facilities mainly for the wealth of information that controlling energy infrastructure assets provides to help one's energy traders manipulate trading markets. *The Wall Street Journal* reported that financial speculators were snapping up leasing rights in Cushing, Ok.[53]

In August 2006, Goldman Sachs, AIG and Carlyle/Riverstone announced the $22 billion acquisition of Kinder Morgan, Inc., which controls 43,000 miles of crude oil, refined products and natural gas pipelines, in addition to 150 storage terminals.

Prior to this huge purchase, Goldman Sachs had already assembled a long list of oil and gas investments. In 2005, Goldman Sachs and private equity firm Kelso & Co. bought a 112,000 barrels/day oil refinery in Kansas operated by CVR Energy, and entered into an oil supply agreement with J. Aron, Goldman's energy trading subsidiary. Goldman's Scott L. Lebovitz & Kenneth A. Pontarelli and Kelso's George E. Matelich & Stanley de J. Osborne all serve on CVR Energy's Board of Directors.

In May 2004, Goldman spent $413 million to acquire royalty rights to more than 1,600 natural gas wells in Pennsylvania, West Virginia, Texas, Oklahoma and offshore Louisiana from Dominion Resources. Goldman Sachs owns a six percent stake in the 375 mile Iroquois natural gas pipeline, which runs from Northern New York through Connecticut to Long Island. In December 2005, Goldman and Carlyle/Riverstone together are investing $500 million in Cobalt International Energy, a new oil exploration firm run by former Unocal executives.

Conclusion

This era of high energy prices isn't a simple case of supply and demand, as the evidence suggests that weak or non-existent regulatory oversight of energy trading markets provides opportunity for energy companies and financial institutions to price-gouge Americans. Forcing consumers suffering from inelastic demand to continue to pay high prices—in part fueled by uncompetitive actions—not only hurts consumers economically, but environmentally as well, as the oil companies and en-

[49] *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf,* page 26.

[50] *http://idea.sec.gov/Archives/edgar/data/895421/000119312509013429/d10k.htm.*

[51] Paul Merolli, "Two Morgan Stanley M&A deals show bullish stance on gas," *Natural Gas Week,* Volume 19; Issue 28, July 14, 2003.

[52] Brian Baskin, "SemGroup Loses Bets on Oil; Hedging Tactics Coincide With Ebb In Price of Crude," July 24, 2008, Page C14.

[53] Ann Davis, "Where Has All The Oil Gone?" October 6, 2007, Page A1.

ergy traders enjoying record profits are not investing those earnings into sustainable energy or alternatives to our addiction to oil. Reforms to strengthen regulatory oversight over America's energy trading markets are needed to restore true competition to America's oil and gas markets.

Solutions

- Re-regulate energy trading markets by subjecting OTC exchanges—including foreign-based exchanges trading U.S. energy products—to full compliance under the Commodity Exchange Act and mandate that all OTC energy trades adhere to the CFTC's Large Trader reporting requirements. In addition, regulations must be strengthened over existing lightly-regulated exchanges like NYMEX.
- Impose legally-binding firewalls to limit energy traders from speculating on information gleaned from the company's energy infrastructure affiliates or other such insider information, while at the same time allowing legitimate hedging operations. Congress must authorize the FTC and DOJ to place greater emphasis on evaluating anti-competitive practices that arise out of the nexus between control over hard assets like energy infrastructure and a firm's energy trading operations. Incorporating energy trading operations into anti-trust analysis must become standard practice for Federal regulatory and enforcement agencies to force more divestiture of assets in order to protect consumers from abuses.
- Raise margin requirements so market participants will have to put up more of their own capital in order to trade energy contracts, and impose aggregate position limits on noncommercial trading to reduce speculation. Currently, margin requirements are too low, which encourages speculators to more easily enter the market by borrowing, or leveraging, against their positions. And aggregated limits over all markets—not just select ones—would preclude an energy trader from dipping their hands in multiple futures market cookie jars with the intent to speculate.

The CHAIRMAN. Thank you, Mr. Slocum.

Thank both of you for being with us today.

I hadn't really thought about, Mr. Slocum, what you had brought up there. I don't really agree with the terminology "speculation" for what Goldman Sachs is doing. Because they have created an investment that they are selling to people. That is going into the market, and they are using the regulated market to hedge their risks and so forth.

So, the fact that they are selling an index that has 10 percent corn, 40 percent oil, and eight percent copper or whatever, that is going into the market based on those percentages, and there is not a whole lot of thought going into it. It is just an investment vehicle they are selling to people.

I am not sure there is anybody sitting around there scheming what is going to happen. They are just getting their commissions by selling these investments to pension funds and some of these other people. They are putting out this information, they are still running seminars trying to convince people that they ought to take their money out of other areas and put them into commodities because they can make more money because oil prices are going up or whatever.

So I don't know if I can connect the dots there. But I do have, personally, a concern about this money that has been coming into this market from these areas that don't have anything to do with the underlying commodity situation.

In fact, the first draft I put out last year banned pension funds from being involved in this commodity market at all, which I still personally believe we should do. I am just waiting for the day for the pension funds to come to the United States Congress and tell us that we have to bail them out because of this failed strategy that cost them all this money in their pension funds, and now they can't pay the benefits. That is probably going to come at some point here, too.

But we will take that under consideration, and I guess I would like to learn more about what you think the connection is there.

Mr. Roth, you have some proposed ideas on how to get a handle on this retail stuff that is going on?

Mr. ROTH. Exactly, Mr. Chairman. We have language that we would be happy to share with the staff and with Members of the Committee. It is language that we have circulated before, but we think it has broad support.

The CHAIRMAN. You might find a more receptive audience now. Times have changed.

The gentleman from Texas, Mr. Conaway.

Mr. CONAWAY. Thank you, Mr. Chairman.

I don't have a lot to say, other than I share Mr. Roth's concern about bucket shops and preying on the uninformed and folks that shouldn't be in these markets.

Mr. Slocum, I am a little bit concerned about some of the allegations that you kind of throw around. I am assuming you have empirical evidence behind everything you accused folks of doing in your opening statement.

Mr. SLOCUM. The accusation of what, that there was a——

Mr. CONAWAY. The rampant speculation for one thing. You have empirical evidence on that?

Mr. SLOCUM. Absolutely. I wasn't accusing anyone of manipulating markets.

Mr. CONAWAY. Which is, sir?

Mr. SLOCUM. Which is data from the CFTC, which is numerous other——

Mr. CONAWAY. And the fact the Chairman of the CFTC has been in here numerous times saying the data that we have, we can't find market manipulation from rampant speculation.

Mr. SLOCUM. And there have been numerous criticisms of——

Mr. CONAWAY. I understand. Nobody likes it. Nobody likes the high prices. Nobody likes the run-up. But we have to be careful that we use evidence to try to determine public policy. Just because we don't like something doesn't mean that it is automatically some kind——

Mr. SLOCUM. I am not discussing likes and dislikes. I am talking about an unprecedented rise and then collapse of crude oil prices; where any analyst examining it could see a wide disconnect between supply-demand fundamentals. When you have prices rise that quickly, demand does not collapse overnight. There were no new massive oil fields that appeared. This collapse in oil prices was directly the result of the inability of financial players who were betting on these markets——

Mr. CONAWAY. You have evidence to that?

Mr. SLOCUM. Well, it is my knowledge of the way that the futures markets work.

Mr. CONAWAY. Yes. Your interest in restricting the physical assets that go along with certain commodities, how do you—the guy that grows corn, you would restrict him from being able to work in these markets as well?

Mr. SLOCUM. My experience and expertise is on energy markets.

Mr. CONAWAY. Okay. I am an oil and gas producer, and I drill for oil and gas. I find some reserves. I get a petroleum engineer who gives me an estimate of that value. I go to my bank and want to borrow against that reserve. The bank says, well, you can do that, but you have to hedge the price that you used in your valuation contest. I own the barrels. I am long the barrels. I can somehow manipulate the system by doing that?

Mr. SLOCUM. No. There is a difference between what I consider legitimate hedging and what I consider speculation. So a legitimate hedger, sir, would be someone like a Valero Energy, which is based in Texas.

Mr. CONAWAY. Why would Goldman Sachs not be a legitimate hedger? If they own Kinder Morgan and they own the assets, the long assets, why would they not be a——

Mr. SLOCUM. Well, they have no physical delivery commitments. They acquire ownership over transportation——

Mr. CONAWAY. Right.

Mr. SLOCUM.—of oil, so they are not responsible for physically delivering. There is no one in a Goldman Sachs uniform delivering home heating oil to my family in New England. There are other entities that are doing that.

The Chairman raised the point about Goldman's index fund, which is a passive player. But Goldman also has an extensive futures operation outside of its index fund, where they are a major player in the futures markets.

Mr. CONAWAY. Okay. Reclaiming my time, Mr. Slocum, you said there were 80 million barrels on the high seas?

Mr. SLOCUM. Eighty million barrels——

Mr. CONAWAY. That is how much of a production?

Mr. SLOCUM. I am sorry? That is enough for a day's worth of——

Mr. CONAWAY. Okay. Just to make sure I understand, what is the holding cost on 80 million barrels? In other words, you have to finance it. What is your interest hold on 80 million barrels?

Mr. SLOCUM. Well, according to the article, the daily rate for a supertanker to hold a million or 2 million barrels of oil a day was in the range of like $40,000 to $70,000 a day.

Mr. CONAWAY. So multiply that times 80.

Mr. SLOCUM. Right. It is a big number.

Mr. CONAWAY. It is a big number, a huge number. So is there some nefarious reason I would do that and incur those costs?

Mr. SLOCUM. Because you can make more money holding it and by controlling these physical assets.

Mr. CONAWAY. But isn't that what buying and selling is all about?

Mr. SLOCUM. Sure. But the concern I have is when this occurs in an unregulated format by players who do not have physical delivery commitments.

Mr. CONAWAY. If I have 80 million barrels in tankers, I have the asset. I am long the barrels.

Mr. SLOCUM. Right. But your primary purpose of holding that and hoarding that is not to physically deliver it but to take it off the market.

Mr. CONAWAY. So I am now hoarding?

Mr. SLOCUM. That is right. That is the definition of hoarding, sir, and the concern I have——

Mr. CONAWAY. To buy inventory in anticipation that it would go up later and I could sell it later, that I am a hoarder at this point now?

Mr. SLOCUM. If you are a financial firm whose primary focus is——

Mr. CONAWAY. Is making money.

Mr. SLOCUM.—entering into the futures market and you are acquiring or leasing storage facilities for the sole purpose of supplementing your trading desk, that is hoarding. And I am not asking——

Mr. CONAWAY. Okay. If I am a financial company, I am buying stocks with the anticipation that those go up, and they go up because there is a shortage of folks who want to sell, I am now a hoarder?

Mr. SLOCUM. Well, the difference in commodities markets is, if I have information about the movement or storage levels of a commodity——

Mr. CONAWAY. Right. And who has——

Mr. SLOCUM.—that gives me a massive insider's peek, an information advantage as to how other traders are going to react. By having control over pipelines or storage facilities, you have access to proprietary data that is not widely available to other speculators in the marketplace. So, as Morgan Stanley notes in its own annual report, that getting control over those storage facilities plays a very integral role in their trading operations. And their trading operations are purely speculative. They do not have physical delivery commitments.

Mr. CONAWAY. As the Chairman already said, they are using those operations to create instruments that they sell to their customers. They themselves are trying to make money. You and I are unlikely to agree on much of this, Mr. Slocum, but I appreciate you coming today and will yield back to the Chairman.

Mr. ROTH. If I could just add one historical perspective.

The CHAIRMAN. Sure.

Mr. ROTH. I mean, there are laws on the books right now against manipulation of markets; and there have been cases brought by the CFTC in which an integral part of the manipulation effort was a control over the delivery points, or the control of the delivery ability of the underlying commodity. So it is an interesting question that you pose, but there are anti-manipulation laws in effect that have been applied to the circumstances similar to those that you describe.

Mr. SLOCUM. Right. The case that caused Public Citizen to look at this on our radar screen was last year when British Petroleum, a major oil company, agreed to a $300 million settlement when it attempted to manipulate the entire U.S. market for propane, and they did it when their energy traders were communicating with their propane pipeline and storage affiliates. But the only reason that regulators knew about it was because an internal employee at BP blew the whistle.

The ability of regulators to examine that kind of activity is limited, which is why I suggested to the Committee that in legislation we should consider examining whether or not this is a problem.

The CHAIRMAN. Thank you very much.

The gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman.

Mr. Roth, It has been 4, 5 years now we have been working on a *Zelener* fix; and it sure would be nice to get one that is more effective than what we have done in the past. I think we will; and I appreciate you being persistent, a nag as you described it, on that subject.

What do you think about the legislation that we have otherwise, our efforts with regard to credit default swaps, transparency, regulating or banning or severely limiting naked swaps, that sort of thing?

Mr. ROTH. We make a couple of points in my written testimony.

Mr. MARSHALL. If you want to just refer to your written testimony, that is fine.

Mr. ROTH. That is fine. I would be happy to summarize a couple of points quickly.

It was interesting to watch the previous panel. With respect to naked credit default swaps, it seemed to me that Mr. Greenberger's point was he was not worried about hedgers in those markets, he just wanted to deal with the speculators. The point is, as was made by many people, that you can't deal with the speculators without affecting the hedgers, and that I am not aware of any derivative market anyplace that can survive without liquidity. I don't know of any market that can have liquidity without speculators. So, your idea of looking for some form of compromise on that point is the right path to be traveling.

Mr. MARSHALL. Okay. Mr. Slocum, just an observation, something I am sure that you are already aware of, but the CEA permits people to trade on insider information. And so to the extent that you are wondering whether or not we should permit parties to have physical assets that are associated with the futures that they are trading and the derivatives that they are trading in. You are wondering whether or not we should revisit altogether, at least if you are worried about insider trading, revisit altogether the CEA's permission to use insider trading, the whole idea there being that we want to get the best possible angle on what the right price is and that that helps the entire market. It helps all the farmers. It helps the elevators. It helps everybody.

I think you are absolutely right, that to the extent that there is an entity that has control of a substantial or a critical part of the physical infrastructure associated with a particular market, and at the same time is in the derivatives or futures market, there can be a temptation to use physical control, somehow, for manipulation— not just information but to actually manipulate the market.

As Mr. Roth has pointed out, we have laws that address that. You are worried that a lot of the fraud that could potentially occur as a result of this kind of control is not really discoverable. So you might want to suggest ways in which we could enhance our ability to discover problems along those lines.

I will just make one further observation. We heard lots of testimony last year that one of the reasons why there wasn't convergence, and one of the reasons why the futures markets weren't working effectively is because we didn't have enough storage for delivery. Some of us said how we deliver products should not be driven by the way these contracts are drafted, and it is kind of stupid for all of us, for the world to reorganize itself just to meet this contractual need that could be changed. Others said, no there is a real reason why these contracts are so narrowly drawn, that delivery has to be in a particular place.

So it is not farfetched for me to think that Morgan Stanley and others legitimately are concerned about delivery and the ability to deliver, and the ability to store those sorts of things and want to do that to enhance their ability to participate in these markets, given what happened over the last few years. I suspect that is the argument they would make.

So if you could just help us out, not necessarily right now—but with some specific suggestions for how we enhance our ability to determine who is manipulating, that would be enormously helpful to us.

Mr. SLOCUM. Right. Well, just to very quickly respond, the Federal Energy Regulatory Commission, which has jurisdiction over natural gas storage facilities, has explicit Code of Conduct rules prohibiting an entity that has controller ownership over natural gas storage from communicating with any affiliates that are engaged in the futures market for natural gas. For natural gas, there are very explicit barriers that do not exist for crude oil and other petroleum products.

So Public Citizen is only seeking that crude oil and other petroleum products are treated the same as natural gas; and since this is a hearing about futures markets and abuses that have occurred in the futures market, it is entirely appropriate. Again, it must be crafted in a way that does not inhibit what I see as legitimate hedging.

The example I was trying to give earlier was of Valero in San Antonio, a major independent refiner. They do not produce any oil themselves, but they refine oil into useful products that we all need. They absolutely must go into the futures market to hedge for their basic business operations.

I do not want to inhibit their ability to do that. I do want to inhibit what I see as a purely financial speculator, like a Goldman Sachs, like a Morgan Stanley, who is getting into the physical ownership and control of energy assets purely to supplement their futures operation. That I do not think is economically useful for the United States.

Mr. MARSHALL. We very much appreciate what both of you and your organizations do to help the citizens of the United States.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The gentleman from Iowa, Mr. Boswell.

Mr. BOSWELL. Thank you, Mr. Chairman.

I had to step out. I apologize. If this has been asked, just stop me.

But, to Mr. Roth, I guess we will get better acquainted as I take on the new responsibility with commodities and risk management that the Chairman has seen so fit to give me, but we will talk more as time goes on.

But I am concerned. There is a lot of blame for hastening the downward spiral for the naked credit default swaps. Would you just comment some more on that? That is done through, some say, bad actors; to short a company and then drive the company down by sending market signs through the CDS market, decreases the company's ability to borrow or raise capital, while other companies require higher margin capital requirements.

How would you propose Congress weighs a systemic risk to the market without lending legitimate risk mitigation strategy?

Mr. ROTH. Well, as the previous panel indicated, the natural evolution of these products toward a centralized clearing is a beneficial sort of development for everyone and adds greater transparency to the process.

So I think you are right. Anytime there is some sort of a crisis, anytime there is sort of a problem, there is always a desire to point the finger and usually at somebody else.

So with respect to credit default swaps, I am not aware of any financial derivative product which has thrived that didn't serve a valid and useful economic purpose. So I am assuming that there is a valid and useful economic purpose to these instruments.

I think that the more transparency Congress can bring to these instruments the better. The fact that they are moving towards centralized clearing is helpful; and, at the same time, as Mr. Duffy and others provided, or pointed out, it is hard to put a round peg in a square hole. Certain instruments simply cannot be cleared because of their highly individualized nature.

I know the draft bill has exemptive authority in there for the CFTC. I would just try to draft that legislation, that section of the bill in such a way to give the Commission maximum flexibility. Because to try to delineate in a statute all the different factors that would be appropriate to consider is very tough drafting, and I would emphasize the need to give the Commission as much flexibility as possible.

Mr. BOSWELL. Thank you. I yield back.

The CHAIRMAN. I thank the gentleman.

The gentleman from Wisconsin, Mr. Kagen.

Mr. KAGEN. Thank you, Mr. Chairman.

Mr. Roth, I have read your very brief report, and in it on page 5 you indicated, "NFA supports efforts to bring greater transparency to these transactions"—referring to CDS credit default swaps—"and to reduce their systemic risk."

So what specific recommendations would you give towards changing the language of the draft to reduce that system at risk?

Mr. ROTH. Congressman, I have *Zelener* language for you, and I will give you that.

I don't have language sitting in my pocket. What I am concerned about is, with respect to the mandatory clearing of OTC derivatives, the concern would be that, number one, that the Commission not have enough flexibility to grant exemptions. But, and you really need to talk to someone more directly involved in this market than I am, but it is hard for me to understand if two individuals are doing a highly privatized, highly individualized, privately negotiated instrument, and it is the first time they have done this instrument; before they consummate their transaction do they have to call the CFTC and get an exemption so everything is in unless it is out. Every time you do a new deal with a new counterparty you have to go to the CFTC and get an exemption? That strikes me as being an awkward sort of structure.

Those are the types of things I would be looking for. I don't have language for you today, but I would be happy to give it some thought. Again, not directly within NFA's realm, but I would be happy to give some further thought to it. But those are my general concerns.

Mr. KAGEN. Mr. Slocum, would you care to comment on systemic risk?

Mr. SLOCUM. I don't think I have a comment——

Mr. ROTH. Are you against it?

Mr. SLOCUM. Yes.

Mr. KAGEN. Thank you, gentlemen.

The CHAIRMAN. The gentleman from Oregon, Mr. Schrader.

Mr. SCHRADER. Thank you, Mr. Chairman.

I would just be interested in the panel's thoughts on the bill's inclusion of carbon offsets and emission allowances that are being proposed for the CFTC to have jurisdiction over. There is going to be some interesting legislative discussions about who should, indeed, have jurisdiction as this process moves forward.

So we heard great things about the CFTC as a regulator it has done a wonderful job. This particular market, as long as it is allowed to regulate certain instruments, has done a great job. Is this the appropriate place, the CFTC, to regulate that market?

Mr. ROTH. Well, there is already a market that the CFTC is regulating. My question, when I read that section of the bill, is whether the language is necessary. I mean, do we think the CFTC lacks jurisdiction to oversee a futures contract market that trades those types of products? I don't think so.

So, to me—and I am sorry, Congressman. I didn't study it in depth. But when I read the bill, my question was whether the language was surplusage, whether it was really necessary.

Mr. SLOCUM. Well, I actually think it is necessary. Because what I see is a jurisdictional fight between Members of the Energy and Commerce Committee and Members here of the Agriculture Committee, where I know that, in drafts of climate bills put together by Energy and Commerce Committee Members, they are putting jurisdiction of carbon markets under the Federal Energy Regulatory Commission where they have regulatory jurisdiction.

I actually agree with the approach taken here. The CFTC is actually the most relevant and most prepared agency to regulate an economy-wide cap and trade program with emissions credits and all of that. So I do think that you need to include it here, because this is going to become a very big issue this year, and it is crucial that the CFTC have jurisdiction over this new market.

Mr. SCHRADER. I yield back the rest of my time, sir.

The CHAIRMAN. I thank the gentleman.

That is why we included it. I don't have any problem with the FERC regulating the cash market, whatever cash market there might be in these credits, but we have enough problems; the FERC has never regulated any futures situation. Why would we get them into that?

There are people over in that other Committee that think that they should reinvent the wheel or something.

Mr. ROTH. Congressman, anything you have to do to defend the CFTC's exclusive jurisdiction is something that we would strongly support.

The CHAIRMAN. Right. So it is a preemptive strike.

Anyway, thank you very much for being with us today. You added to the hearing. We appreciate you being patient and waiting to get on the panel and thank all the members.

Mr. Conaway, do you have anything to say?

Mr. CONAWAY. No, but I appreciate both witnesses coming and hanging in there all afternoon until the very end. We appreciate that.

One of the good things about being last is that you don't have to stay very long. So, anyway, we thank both of you for coming today. We appreciate it.

The CHAIRMAN. All right. I thank the panel. I thank the Committee Members. The Committee stands adjourned subject to the call of the chair.

[Whereupon, at 4:10 p.m., the Committee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED STATEMENT BY AMERICAN PUBLIC GAS ASSOCIATION

Chairman Peterson, Ranking Member Lucas and Members of the Committee, the American Public Gas Association (APGA) appreciates this opportunity to submit testimony to you today. We also commend the Committee for calling this hearing on the important subject of derivative trading. APGA would also like to commend Chairman Peterson and the House Agriculture Committee for its ongoing focus on market transparency and oversight.

APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and over 700 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities.

APGA's number one priority is the safe and reliable delivery of affordable natural gas. To bring natural gas prices back to a long-term affordable level, we ultimately need to increase the supply of natural gas. However, equally critical is to restore public confidence in the pricing of natural gas. This requires a level of transparency in natural gas markets which assures consumers that market prices are a result of fundamental supply and demand forces and not the result of manipulation, excessive speculation or other abusive market conduct.

We, along with other consumer groups, have watched with alarm over the last several years certain pricing anomalies in the markets for natural gas. More recently, we have noted much greater volatility in the price of energy and other physical commodities. APGA has strongly supported an increase in the level of transparency with respect to trading activity in these markets from that which currently exists. We believe that additional steps are needed in order to restore our current lack of confidence in the natural gas marketplace and to provide sufficient transparency to enable the CFTC, and market users, to form a reasoned response to the critically important questions that have been raised before this Committee during the course of these hearings.

APGA believes that the increased regulatory, reporting and self-regulatory provisions relating to the unregulated energy trading platforms contained in legislation that reauthorizes the Commodity Futures Trading Commission ("CFTC") is a critically important first step in addressing our concerns. Those provisions are contained in Title XIII of the farm bill which has become law. We commend this Committee for its work on this important legislation. The market transparency language that was included in the farm bill will help shed light on whether market prices in significant price discovery energy contracts are responding to legitimate forces of supply and demand or to other, non-*bona fide* market forces.

However, APGA believes that more can, and should, be done to further increase transparency of trading in the energy markets. Many of these steps would likely also be useful in better understanding the current pricing trends in the markets for other physical commodities as well.

Although the additional authorities which have been provided to the CFTC under Title XIII of the 2008 Farm Bill will provide the CFTC with significant additional tools to respond to the issues raised by this hearing (at least with respect to the energy markets), we nevertheless believe that it may be necessary for Congress to provide the CFTC with additional statutory authorities. We are doubtful that the initial steps taken by the reauthorization legislation are, or will be, sufficient to fully respond to the concerns that we have raised regarding the need for increased transparency. In this regard, we believe that additional transparency measures with respect to transactions in the Over-the-Counter markets are needed to enable CFTC to assemble a more complete picture of a trader's position and thereby understand a large trader's potential impact on the market.

We further believe, that in light of the critical importance of this issue to consumers, that this Committee should maintain active and vigilant oversight of the CFTC's market surveillance and enforcement efforts, that Congress should be prepared to take additional legislative action to further improve transparency with respect to trading in energy contracts and, should the case be made, to make additional amendments to the Commodity Exchange Act, 7 U.S.C. § 1 *et seq.* ("Act"), that allows for reasonable speculative position limits in order to ensure the integrity of the energy markets.

Speculators' Effect on the Natural Gas Market

As hedgers that use both the regulated futures markets and the OTC energy markets, we value the role of speculators in the markets. We also value the different needs served by the regulated futures markets and the more tailored OTC markets.

As hedgers, we depend upon liquid and deep markets in which to lay off our risk. Speculators are the grease that provides liquidity and depth to the markets.

However, speculative trading strategies may not always have a benign effect on the markets. For example, the 2006 blow-up of Amaranth Advisors LLC and the impact it had upon prices exemplifies the impact that speculative trading interests can have on natural gas supply contracts for local distribution companies ("LDCs"). Amaranth Advisors LLC was a hedge fund based in Greenwich, Connecticut, with over $9.2 billion under management. Although Amaranth classified itself as a diversified multi-strategy fund, the majority of its market exposure and risk was held by a single Amaranth trader in the OTC derivatives market for natural gas.

Amaranth reportedly accumulated excessively large long positions and complex spread strategies far into the future. Amaranth's speculative trading wagered that the relative relationship in the price of natural gas between summer and winter months would change as a result of shortages which might develop in the future and a limited amount of storage capacity. Because natural gas cannot be readily transported about the globe to offset local shortages, the way for example oil can be, the market for natural gas is particularly susceptible to localized supply and demand imbalances. Amaranth's strategy was reportedly based upon a presumption that hurricanes during the summer of 2006 would make natural gas more expensive in 2007, similar to the impact that Hurricanes Katrina and Rita had had on prices the previous year. As reported in the press, Amaranth held open positions to buy or sell tens of billions of dollars of natural gas.

As the hurricane season proceeded with very little activity, the price of natural gas declined, and Amaranth lost approximately $6 billion, most of it during a single week in September 2006. The unwinding of these excessively large positions and that of another previously failed $430 million hedge fund—MotherRock—further contributed to the extreme volatility in the price of natural gas. The Report by the Senate Permanent Subcommittee on Investigations affirmed that "Amaranth's massive trading distorted natural gas prices and increased price volatility." [1]

Many natural gas distributors locked-in prices prior to the period Amaranth collapsed at prices that were elevated due to the accumulation of Amaranth's positions. They did so because of their hedging procedures which require that they hedge part of their winter natural gas in the spring and summer. Accordingly, even though natural gas prices were high at that time, it would have been irresponsible (and contrary to their hedging policies) to not hedge a portion of their winter gas in the hope that prices would eventually drop. Thus, the elevated prices which were a result of the excess speculation in the market by Amaranth and others had a significant impact on the price these APGA members, and ultimately their customers, paid for natural gas. The lack of transparency with respect to this trading activity, much of which took place in the OTC markets, and the extreme price swings surrounding the collapse of Amaranth have caused *bona fide* hedgers to become reluctant to participate in the markets for fear of locking-in prices that may be artificial.

Recently, additional concerns have been raised with respect to the size of positions related to, and the role of, passively managed long-only index funds. In this instance, the concern is not whether the positions are being taken in order to intentionally drive the price higher, but rather whether the unintended effect of the cumulative size of these positions has been to push market prices higher than the fundamental supply and demand situation would justify.

The additional concern has been raised that recent increased amounts of speculative investment in the futures markets generally have resulted in excessively large speculative positions being taken that due merely to their size, and not based on any intent of the traders, are putting upward pressure on prices. The argument made is that these additional inflows of speculative capital are creating greater demand then the market can absorb, thereby increasing buy-side pressure which results in advancing prices.

Some have responded to these concerns by reasoning that new futures contracts are capable of being created without the limitation of having to have the commodity physically available for delivery. This explains why, although the open-interest of futures markets can exceed the size of the deliverable supply of the physical commodity underlying the contract, the price of the contract could nevertheless reflect the forces of supply and demand.

As we noted above, as hedgers we rely on speculative traders to provide liquidity and depth to the markets. Thus, we do not wish to see steps taken that would discourage speculators from participating in these markets using *bona fide* trading strategies. But more importantly, APGA's members rely upon the prices generated

[1] *See "Excessive Speculation in the Natural Gas Market,"* Report of the U.S. Senate Permanent Subcommittee on Investigations (June 25, 2007) ("PSI Report") at p. 119.

by the futures to accurately reflect the true value of natural gas. Accordingly, APGA would support additional regulatory controls, such as stronger speculative position limits, if a reasoned judgment can be made based on currently available, or additional forthcoming market data and facts, that such controls are necessary to address the unintended consequences arising from certain speculative trading strategies or to reign in excessively large speculative positions. To the extent that speculative investment may be increasing the price of natural gas or causing pricing aberrations, we strongly encourage Congress to take quick action to expand market transparency in order to be able to responsibly address this issue and protect consumers from additional cost burdens. Consumers should not be forced to pay a "speculative premium."

The Markets in Natural Gas Contracts

The market for natural gas financial contracts is composed of a number of segments. Contracts for the future delivery of natural gas are traded on NYMEX, a designated contract market regulated by the CFTC. Contracts for natural gas are also traded in the OTC markets. OTC contracts may be traded on multi-lateral electronic trading facilities which are exempt from regulation as exchanges, such as the IntercontinentalExchange ("ICE"). ICE also operates an electronic trading platform for trading non-cleared (bilateral) OTC contracts. They may also be traded in direct, bilateral transactions between counterparties, through voice brokers or on electronic platforms. OTC contracts may be settled financially or through physical delivery. Financially-settled OTC contracts often are settled based upon NYMEX settlement prices and physically delivered OTC contracts may draw upon the same deliverable supplies as NYMEX contracts, thus linking the various financial natural gas market segments economically.

Increasingly, the price of natural gas in many supply contracts between suppliers and local distribution companies, including APGA members, is determined based upon monthly price indexes closely tied to the monthly settlement of the NYMEX futures contract. Accordingly, the futures market serves as the centralized price discovery mechanism used in pricing these natural gas supply contracts.

Generally, futures markets are recognized as providing an efficient and transparent means for discovering commodity prices.[2] However, any failure of the futures price to reflect fundamental supply and demand conditions results in prices for natural gas that are distorted and do not reflect its true value.[3] This has a direct affect on consumers all over the U.S., who as a result of such price distortions, will not pay a price for the natural gas that reflects *bona fide* demand and supply conditions. If the futures price is manipulated or distorted, then the price consumers pay for the fuel needed to heat their homes and cook their meals will be similarly manipulated or distorted.

Today, the CFTC provides generally effective oversight of futures exchanges and the CFTC and the exchanges provide a significant level of transparency. And under the provisions of the Title XIII of the farm bill, the CFTC has been given additional regulatory authority with respect to significant price discovery contracts traded on exempt commercial markets, such as ICE. This is indeed a major step toward greater market transparency. However, even with this additional level of transparency, a large part of the market remains opaque to regulatory scrutiny. The OTC markets lack such price transparency. This lack of transparency in a very large and rapidly growing segment of the natural gas market leaves open the potential for a participant to engage in manipulative or other abusive trading strategies with little risk of early detection; and for problems of potential market congestion to go undetected by the CFTC until after the damage has been done to the market.

Equally significant, even where the trading is not intended to be abusive, the lack of transparency for the over-all energy markets leaves regulators unable to answer questions regarding speculators' possible impacts on the market. For example, do we know who the largest traders are in the over-all market, looking at regulated fu-

[2] *See* the Congressional findings in section 3 of the Commodity Exchange Act, 7 U.S.C. § 1 *et seq.* ("Act"). Section 3 of the Act provides that, "The transactions that are subject to this Act are entered into regularly in interstate and international commerce and are affected with a national public interest by providing a means for . . . discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities." A further question with respect to whether other speculative strategies, or excessively large speculative positions is also distorting market prices by pushing prices higher than they otherwise would be.

[3] The effect of Amarath's trading resulted in such price distortions. *See generally PSI Report.* The PSI Report on page 3 concluded that "Traders use the natural gas contract on NYMEX, called a futures contract, in the same way they use the natural gas contract on ICE, called a swap. . . . The data show that prices on one exchange affect the prices on the other."

tures contracts, significant price discovery contracts and bilateral OTC transactions? Without being able to see a large trader's entire position, it is possible that the effect of a large OTC trader on the regulated markets is masked, particularly when that trader is counterparty to a number of swaps dealers that in turn take positions in the futures market to hedge these OTC exposures as their own.

Regulatory Oversight

NYMEX, as a designated contract market, is subject to oversight by the CFTC. The primary tool used by the CFTC to detect and deter possible manipulative activity in the regulated futures markets is its large trader reporting system. Using that regulatory framework, the CFTC collects information regarding the positions of large traders who buy, sell or clear natural gas contracts on NYMEX. The CFTC in turn makes available to the public aggregate information concerning the size of the market, the number of reportable positions, the composition of traders (commercial/noncommercial) and their concentration in the market, including the percentage of the total positions held by each category of trader (commercial/noncommercial).

The CFTC also relies on the information from its large trader reporting system in its surveillance of the NYMEX market. In conducting surveillance of the NYMEX natural gas market, the CFTC considers whether the size of positions held by the largest contract purchasers are greater than deliverable supplies not already owned by the trader, the likelihood of long traders demanding delivery, the extent to which contract sellers are able to make delivery, whether the futures price is reflective of the cash market value of the commodity and whether the relationship between the expiring future and the next delivery month is reflective of the underlying supply and demand conditions in the cash market.[4]

Title XIII of the 2008 Farm Bill, empowered the CFTC to collect large trader information with respect to "significant price discovery contracts" traded on the ICE trading platform. However, there remain significant gaps in transparency with respect to trading of OTC energy contracts, including many forms of contracts traded on ICE. Despite the links between prices for the NYMEX futures contract and the OTC markets in natural gas contracts, this lack of transparency in a very large and rapidly growing segment of the natural gas market leaves open the potential for participants to engage in manipulative or other abusive trading strategies with little risk of early detection and for problems of potential market congestion to go undetected by the CFTC until after the damage has been done to the market, ultimately costing the consumers or producers of natural gas. More profoundly, it leaves the regulator unable to assemble a true picture of the over-all size of a speculator's position in a particular commodity.

Greater Transparency Needed

Our members, and the customers served by them, believe that although Title XIII of the 2008 Farm Bill goes a long way to addressing the issue, there is not yet an adequate level of market transparency under the current system. This lack of transparency has led to a growing lack of confidence in the natural gas marketplace. Although the CFTC operates a large trader reporting system to enable it to conduct surveillance of the futures markets, it cannot effectively monitor trading if it receives information concerning positions taken in only one, or two, segments of the total market. Without comprehensive large trader position reporting, the government will remain handicapped in its ability to detect and deter market misconduct or to understand the ramifications for the market arising from unintended consequences associated with excessive large positions or with certain speculative strategies. If a large trader acting alone, or in concert with others, amasses a position in excess of deliverable supplies and demands delivery on its position and/or is in a position to control a high percentage of the deliverable supplies, the potential for market congestion and price manipulation exists. Similarly, we simply do not have the information to analyze the over-all effect on the markets from the current practices of speculative traders.

Over the last several years, APGA has pushed for a level of market transparency in financial contracts in natural gas that would routinely, and prospectively, permit the CFTC to assemble a complete picture of the overall size and potential impact of a trader's position irrespective of whether the positions are entered into on NYMEX, on an OTC multi-lateral electronic trading facility which is exempt from regulation or through bilateral OTC transactions, which can be conducted over the telephone, through voice-brokers or via electronic platforms. APGA is optimistic that the enhanced authorities provided to the CFTC in the provisions of the CFTC reau-

[4] *See* letter to the Honorable Jeff Bingaman from the Honorable Reuben Jeffery III, dated February 22, 2007.

thorization bill will help address the concerns that we have raised, but recognizes that more needs to be done to address this issue comprehensively.

Additional Potential Enhancements in Transparency

In supporting the CFTC reauthorization bill, we previously noted that only a comprehensive large trader reporting system would enable the CFTC, while a scheme is unfolding, to determine whether a trader, such as Amaranth, is using the OTC natural gas markets to corner deliverable supplies and manipulate the price in the futures market.[5] A comprehensive large trader reporting system would also enable the CFTC to better detect and deter other types of market abuses, including for example, a company making misleading statements to the public or providing false price reporting information designed to advantage its natural gas trading positions, or a company engaging in wash trading by taking large offsetting positions with the intent to send misleading signals of supply or demand to the market. Such activities are more likely to be detected or deterred when the government is receiving information with respect to a large trader's overall positions, and not just those taken in the regulated futures market. It would also enable the CFTC to better understand the overall size of speculative positions in the market as well as the impact of certain speculative investor practices or strategies on the future's markets ability to accurately reflect fundamental supply and demand conditions.

Accordingly, APGA supports proposals to further increase and enhance transparency in the energy markets, generally, and in the markets for natural gas, specifically. APGA supports greater transparency with respect to positions in natural gas financial contracts acquired through bilateral transactions. Because bilateral trading can in fact be conducted on an all-electronic venue, and can impact prices on the exchanges even if conducted in a non-electronic environment, it is APGA's position that transparency in the bilateral markets is critical to ensure an appropriate level of consumer protection.

Electronic Bilateral trading

One example of the conduct of bilateral trading on an all-electronic trading platform was "Enron On-line." Enron, using its popular electronic trading platform, offered to buy or sell contracts as the universal counterparty to all other traders using this electronic trading system. This one-to-many model constitutes a dealer's market and is a form of bilateral trading. This stands in contrast to a many-to-many model which is recognized as a multi-lateral trading venue. This understanding is reflected in section 1a(33) of the Commodity Exchange Act, which defines "Trading Facility" as a "group of persons that . . . provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts or transactions by accepting bids and offers made by other participants that are open to multiple participants in the facility or system." On the Enron On-line trading platform, only one participant—Enron—had the ability to accept bids and offers of the multiple participants—its customers—on the trading platform.

Section 1a(3) continues by providing that, "the term 'trading facility' does not include (i) a person or group of persons solely because the person or group of persons constitutes, maintains, or provides an electronic facility or system that enables participants to negotiate the terms of and enter into bilateral transactions as a result of communications exchanged by the parties and not from interaction of multiple bids and multiple offers within a predetermined, nondiscretionary automated trade matching and execution algorithm . . . ." This means that it is also possible to design an electronic platform for bilateral trading whereby multiple parties display their bids and offers which are open to acceptance by multiple parties, so long as the consummation of the transaction is not made automatically by a matching engine.

Both of these examples of bilateral electronic trading platforms might very well qualify for exemption under the current language of sections 2(g) and 2(h)(1) of the Commodity Exchange Act. To the extent that these examples of electronic bilateral trading platforms were considered by traders to be a superior means of conducting bilateral trading over voice brokerage or the telephonic call-around markets, or will not fall within the significant price discovery contract requirements, their use as a substitute for a more-regulated exempt commercial market under section 2(h)(3) of the Act should not be readily discounted.

[5] *See e.g. U.S. Commodity Futures Trading Commission* v. *BP Products North America, Inc.,* Civil Action No. 06C 3503 (N.D. Ill.) filed June 28, 2006.

Non-Electronic Bilateral Trading

Moreover, even if bilateral transactions are not effected on an electronic trading platform, it is nonetheless possible for such direct or voice-brokered trading to affect prices in the natural gas markets. For example, a large hedge fund may trade bilaterally with a number of counterparty/dealers using standard ISDA documentation. By using multiple counterparties over an extended period of time, it would be possible for the hedge fund to establish very large positions with each of the dealer/counterparties. Each dealer in turn would enter into transactions on NYMEX to offset the risk arising from the bilateral transactions into which it has entered with the hedge fund. In this way, the hedge fund's total position would come to be reflected in the futures market. Thus, a prolonged wave of buying by a hedge fund, even through bilateral direct or voice-brokered OTC transactions, can be translated into upward price pressure on the futures exchange.

As NYMEX settlement approaches, the hedge fund's bilateral purchases with multiple dealer/counterparties would maintain or increase upward pressure on prices. By spreading its trading through multiple counterparties, the hedge fund's purchases would attract little attention and escape detection by either NYMEX or the CFTC. In the absence of routine large-trader reporting of bilateral transactions, the CFTC will only see the various dealers' exchange positions and have no way of tying them back to purchases by a single hedge fund.

Given that the various segments of the financial markets that price natural gas are linked economically, it is critical to achieving market transparency that traders holding large positions entered into through bilateral transactions be included in any large-trader reporting requirement. As explained above, by trading through multiple dealers, a large hedge fund would be able to exert pressure on exchange prices similar to the pressure that it could exert by holding those positions directly. Only a comprehensive large-trader reporting system that includes positions entered into in the OTC bilateral markets would enable the CFTC to see the entire picture and trace such positions back to a single source.

If large trader reporting requirements apply only to positions acquired on multilateral electronic trading platforms, traders in order to avoid those reporting requirements may very well move more transactions to electronic bilateral markets or increase their direct bilateral trading. This would certainly run counter to efforts by Congress to increase transparency. APGA remains convinced that all segments of the natural gas marketplace should be treated equally in terms of reporting requirements. To do otherwise leaves open the possibility that dark markets on which potential market abuses could go undetected would persist and that our current lack of sufficient information to fully understand the impact of large speculative traders and certain trading strategies on the markets will continue, thereby continuing to place consumers at risk.

Derivatives Markets Transparency and Accountability Act of 2009

As stated previously, APGA supports proposals to further increase and enhance transparency in the energy markets, generally, and in the markets for natural gas, specifically. APGA commends Chairman Peterson for drafting the Derivatives Markets Transparency and Accountability Act of 2009. This legislation would significantly enhance market transparency and would provide the CFTC with additional needed resources to help ensure that the "cop on the beat" has the tools needed to do its job.

Specifically, this legislation would provide greater transparency with respect to the activities of the Index Funds by requiring them to be separately accounted for in the CFTC's Commitment of Traders Reports. APGA strongly supports provisions in the legislation that would provide greater transparency to the CFTC with respect to bilateral swap contracts.

Another provision in the bill that APGA strongly supports is the requirement that the CFTC appoint at least 100 new full time employees. The CFTC plays a critical role in protecting consumers, and the market as a whole, from fraud, manipulation and market abuses that create distortion. It is essential that the CFTC have the necessary resources, both in terms of employees but also in terms of information technology, to monitor markets and protect consumers from attempts to manipulate the market. This is critical given the additional oversight responsibilities the CFTC will have through the market transparency language included in the 2008 Farm Bill and the additional transparency requirements that APGA is proposing to the Committee.

Over the last several years, trading volumes have doubled while CFTC staffing levels have decreased. In fact, while we are experiencing record trading volumes, employee levels at the CFTC are at their lowest since the agency was created. Further, more complex and comprehensive monitoring practices from the CFTC will require the latest technology. It is critical that CFTC have the necessary tools to catch abuses before they occur. APGA is concerned that if funding for the CFTC is inadequate, so may be the level of protection.

Conclusion

Experience tells us that there is never a shortage of individuals or interests who believe they can, and will attempt to, affect the market or manipulate price movements to favor their market position. The fact that the CFTC has assessed over $300 million in penalties, and has assessed over $2 billion overall in government settlements relating to abuse of these markets affirms this. These efforts to punish those that manipulate or abuse markets or to address those that might innocently distort markets are important. But it must be borne in mind that catching and punishing those that manipulate markets after a manipulation has occurred is not an indication that the system is working. To the contrary, by the time these cases are discovered using the tools currently available to government regulators, our members, and their customers, have already suffered the consequences of those abuses in terms of higher natural gas prices.

Greater transparency with respect to traders' large positions, whether entered into on a regulated exchange or in the OTC markets in natural gas will provide the CFTC with the tools to answer that question and to detect and deter potential manipulative or market distorting activity before our members and their customers suffer harm.

The Committee's ongoing focus on energy markets has raised issues that are vital to APGA's members and their customers. We do not yet have the tools in place to say with confidence the extent to which the pricing mechanisms in the natural gas market today are reflecting market fundamentals or the possible market effects of various speculative trading strategies. However, we know that the confidence that our members once had in the pricing integrity of the markets has been badly shaken.

In order to protect consumers the CFTC must be able to (1) detect a problem before harm has been done to the public through market manipulation or price distortions; (2) protect the public interest; and (3) ensure the price integrity of the markets. Accordingly, APGA and its over 700 public gas system members applaud your continued oversight of the CFTC's surveillance of the natural gas markets. We look forward to working with the Committee towards the passage of legislation that would provide further enhancements to help restore consumer confidence in the integrity of the price discovery mechanism.

STATMENT SUBMITTED BY STEVE SUPPAN, SENIOR POLICY ANALYST, INSTITUTE FOR AGRICULTURE AND TRADE POLICY

The Institute for Agriculture and Trade Policy (IATP) is a 501(c)(3) organization headquartered in Minneapolis, MN with an office in Geneva, Switzerland. IATP, founded over 20 years ago, works locally and globally to ensure fair and sustainable food, farm and trade systems. IATP is grateful for the opportunity to comment on a bill that is crucial for ensuring that commodities exchange activities contribute to the orderly functioning of markets that enable food and energy security.

In November, IATP published "Commodity Market Speculation: Risk to Food Security and Agriculture" (*http://www.iatp.org/iatp/publications.cfm?accountID=451&refID=104414*). The study found that commodity index fund speculation in U.S. commodity exchanges distorted prices and induced extreme price volatility that made the futures and options market unusable for commercial traders. For example, one market consultant estimated that index fund trading accounted for about 30 percent of the nearly $8 a bushel price of corn on the Chicago Board of Trade at the height of the commodities bubble in late June. Until the bubble burst, many country elevators, unable to assess their risk in such volatile markets, had stopped forward contracting, endangering the cash flows and operations of many U.S. farms. The spike in developing country food import bills and increasing food insecurity, both in the United States and around the world, is partly due to the financial damage of deregulated speculation.

While researching this study, I monitored the Committee hearings that contributed to H.R. 6604, "Commodity Exchange Transparency and Accountability Act of 2008." IATP congratulates the Committee for the intense and expedited schedule of hearings and legislative drafting that resulted in the passage of H.R. 6604 and revisions to it in the draft "Derivatives Markets Transparency and Accountability Act of 2009" (hereafter "the Act"). Due to the complexity of the legislation, our comments will only concern a small portion of the Act's provisions.

Section 3. Speculative limits and transparency of off-shore trading and Section 6. Trading limits to prevent excessive speculation

U.S. commodity exchanges have a dominant international influence over both cash and futures prices for many commodities. Because of the affects of that influence on food security and agriculture around the world, it is crucial that U.S. regulation and oversight of commodity exchanges be exemplary for the regulation of other markets. However, incidents of off-shore noncommercial traders benefiting from U.S. commodity exchanges while claiming to be beyond the jurisdiction of the Commodity Exchange Act (CEA) have resulted in the need for the prudent measures of section 3.

The Committee and its staff are to be congratulated for the work undertaken since the passage of H.R. 6604 on September 18 to improve the bill. Particularly noteworthy are the visits of Chairman Peterson and Committee staff to regulatory authorities in London and Brussels both to explain H.R. 6604 and to learn how it might be improved.

Section 3 would do by statute what the Commodities Futures Trading Commission's (hereafter "the Commission") memoranda of understanding with other regulatory authorities have failed to do: to ensure that foreign traders of futures, options and other derivatives cannot trade on U.S. exchanges unless they submit completely to the authorities of the CEA. Section 6 is so drafted as to avoid the possibility of a trade dispute ruling against the United States for "discrimination" against foreign firms in the peculiar trade and investment policy sense of that term. However, the World Trade Organization negotiations seek to further liberalize and deregulate financial services, particularly through the Working Party on Domestic Regulation of the General Agreement on Trade in Services (GATS).[1] The members of the Financial Leaders Group that has lobbied effectively for GATS and U.S. deregulation (and particular regulatory exemptions for their firms) are major recipients of taxpayer bailouts through the Troubled Asset Relief Program.

The Committee should invite testimony from the Office of the U.S. Trade Representative (USTR) concerning U.S. GATS commitments, to ensure that those commitments and/or USTR positions advocated at the GATS negotiations not conflict with sections 3 and 6 or leave them vulnerable to WTO challenge. Furnished with that testimony and documents relevant to it, legislative drafting may be tightened to avoid the possibility of a WTO challenge.

As the Committee is well-aware, the number of contracts held by noncommercial speculators far outweighs those of *bona fide* physical hedgers. The overwhelming dominance of purely financial speculation has induced price volatility that can be neither explained nor justified in terms of physical supply and demand, *bona fide* hedging by commercial traders and/or the amount of purely financial speculation required to clear trades. For example, in May, *The Brock Report* stated, "no [commercial] speculator today can have a combined contract position in corn that exceeds 11 million bushels. Yet, the two biggest index funds [Standard and Poors/Goldman Sachs and Dow Jones/American Insurance Group] control a combined 1.5 billion bushels!"[2]

Section 3 of the Act seeks to close the regulatory exemption granted to Wall Street banks that enabled this massive imbalance between *bona fide* hedging on physical commodities and contracts held purely for financial speculation. However, closing that loophole will not suffice to begin to repair the damage wrought by the speculative position exemption. In 2004, the Security Exchange Commission granted for just a half dozen investment banks an exemption to prudential reserve requirements to cover losses, thus freeing up billions of dollars of speculative capital and handing the chosen banks a huge competitive advantage.[3] These two regulatory exemptions enabled the asset price bubbles that began to burst in July, with dire consequences for the entire financial system and the global economy. The Act should authorize the Commission to work with the SEC to close all exemptions to prudential capital reserve requirements.

Despite the commodities price collapse, Goldman Sachs, whose then CEO Henry Paulson lead the successful campaign to exempt his firm and other paragons of risk management from prudential capital reserve requirements, is estimated to have made $3 billion in net revenue in 2008 from its commodities division alone. The average bonus for a commodities trading managing director is estimated to be $3–$4

[1] Ellen Gould. "Financial Instability and the GATS Negotiations." Canadian Centre for Policy Alternatives. July 2008. *http://www.tradeobservatory.org/library.cfm?refID=103596.*

[2] "A Big Move Lies Ahead." *The Brock Report.* May 23, 2008.

[3] Stephen LaBaton. "Agency's '04 Rule Let Banks Pile Up New Debt, and Risk." *The New York Times.* October 3, 2008.

million in 2008, down 25 percent from 2007.[4] Hence, there is little trader disincentive to exceed whatever speculative position limits that are agreed as a result of the deliberations of the Position Limit Agricultural and Energy Advisory Groups (stipulated by section 6. 4a). The Act provides for no advisory group for base and precious metals, which suggests that those components of the index funds may continue without speculative limits. The Act can readily be amended to provide for a Position Limit Metals Advisory Group. Given the financial service industry incentives structure, there is much to be done in the Act to provide strong disincentives for firms and individual traders to exceed the agreed speculative position limits.

One of the responsibilities of the advisory groups is to submit to the Commission a recommendation about whether the exchanges themselves or the Commission should administer the position limit requirements "with enforcement by both the registered entity and the Commission" (lines 10–12, p. 15). While IATP agrees that the exchanges may have a role to play in administering the position limits requirement, we fail to understand why enforcement is not exclusively the Commission's prerogative. We urge the Committee to modify this provision to remove any suggestion of exchange enforcement authority.

Section 4. Detailed Reporting and Disaggregation of Market Data and Section 5. Transparency and Record Keeping Authorities

The provisions in these sections will help regulators monitor the size, number and value of contracts during the reporting period "to the extent such information is available" (Sec. 4(g)(2)). It is this qualifying last clause that worries IATP, since the Commission's ability to carry out its statutory obligations depends on complete and timely reporting of index fund data that disaggregates the agricultural, energy, base metal and precious metal contract components of these funds. The duration of agricultural futures contracts are typically 90 days, while energy and metals futures are for 6 months to a year. Both sections should stipulate that disaggregation not only concern contract positions held by traders with a *bona fide* commercial interest in the commodity hedged *versus* contracts held by financial speculators. Disaggregated and detailed reporting requirements should also stipulate reporting data from all component commodities contracts of the index funds, taking into account the differences in typical contract duration. Furthermore, the Act should authorize the Commission to stipulate that the reporting period for the disaggregated and detailed data be consistent with the duration of the index funds' component contracts, rather than with the reporting period of the index fund itself. The Act should further stipulate that the privilege to trade may be revoked or otherwise qualified if that trader's reporting does not provide sufficient information for the Commission to determine whether the trader is complying with the CEA as amended.

Section 5 anticipates that traders will exceed the speculative position limits set by the Commission and provides for the terms of a special call by the Commission for trading data to determine whether the violation of the position limit has lead to price manipulation or excessive speculation, as defined in the CEA. Although IATP finds these provisions necessary for prudential regulation, we believe that the Act should stipulate how the Commission should seek to obtain the documents requested in the special call, when the trading facilities are located outside the United States. The Act wisely provides a "Notice and Comment" provision concerning the implementation of the reporting requirements for deals that exceed the speculative position limits. We anticipate that this "Notice and Comment" period will be used and guide the Commission's implementation of section 5 reporting requirements.

Section 7. CFTC Administration

IATP believes that the increase in Commission staff, above that called for in H.R. 6604, is well warranted. The Committee should consider adding to this section a provision for a public ombudsman who could take under consideration evidence of misuse or abuse of the Act's authorities by Commission employees and evidence of damage to market integrity that may result from non-implementation or non-enforcement of the Act's provisions.

Section 9. Review of Over-the-Counter Markets

Because of the prevalence of over-the-counter trades in commodities markets, and the damage to market integrity caused by lack of regulation of OTC trades, the need for speculative position limits on those trades seems all but self-evident. However, the Committee is wise to mandate the Commission's study of the OTC market given the heterogeneity, as well as the sheer volume of OTC contracts. We would suggest,

[4] Ann Davis. "Top Traders Still Expect the Cash." *The Wall Street Journal.* November 19, 2008.

however, that the study not be limited to transactions involving agricultural and energy commodities, but should also include base and precious metals.

Section 10. Study Relating to International Regulation of Energy Commodity Markets

IATP is very disappointed that section 10 has dropped the study of agricultural commodity markets called for in H.R. 6604. The Commission will be better able to carry out its responsibilities if it understands how agricultural commodities are regulated or not on exchanges outside of the United States. While U.S. exchanges are dominant in determining futures and cash prices for many agricultural commodities, there are other influential exchanges for certain commodities. The Commission should study these exchanges to find out whether there are best practices from which U.S. exchanges could benefit. IATP urges the Committee to restore the provision for a study of the international regulation of agricultural commodity markets to section 10.

Section 13. Certain Exclusions and Exemptions Available Only for Certain Transactions Settled and Cleared Through Registered Derivatives Clearing Organizations

We confess to not understanding these amendments to the CEA and to skepticism about the need for the exclusions, exemptions and waivers, in light of the exclusions, exemptions, and waivers whose abuse has helped bankrupt both financial institutions and individual investors. IATP suggests that the Committee add a "Notice and Comment" provision to this section, so that the public has an opportunity to argue for or against individual provisions of this section.

Section 14. Treatment of Emission Allowances and Off-Set Credits

This addition to H.R. 6604 may be premature, as the efficacy of emissions trading for actual reduction of global greenhouse gas emissions is under debate in the negotiations for a new United Nations Framework Convention on Climate Change. IATP believes that the Committee should await the results of the Framework Convention negotiations in December in Copenhagen before deciding whether to add this amendment to the CEA. If the Committee decides to retain this section, it should consider whether the current amendment should be limited to carbon sequestration or whether it should cover other green house gas emissions.

Again, I thank the Committee for the opportunity to submit testimony. I congratulate the Committee on moving forward on this important work. I'm available to answer any questions concerning this testimony.

HEARING TO REVIEW DERIVATIVES LEGISLATION

WEDNESDAY, FEBRUARY 4, 2009

HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Committee met, pursuant to call, at 10:37 a.m., in Room 1300, Longworth House Office Building, Hon. Collin C. Peterson [Chairman of the Committee] presiding.

Members present: Representatives Peterson, Holden, Boswell, Baca, Cardoza, Scott, Marshall, Herseth Sandlin, Cuellar, Costa, Ellsworth, Schrader, Dahlkemper, Massa, Bright, Markey, Kratovil, Boccieri, Pomeroy, Minnick, Lucas, Goodlatte, Moran, Johnson, Graves, Neugebauer, Conaway, Schmidt, Smith, Latta, Luetkemeyer, Thompson, and Cassidy.

Staff present: Adam Durand, Tyler Jameson, John Konya, Scott Kuschmider, Robert L. Larew, Clark Ogilvie, John Riley, April Slayton, Debbie Smith, Kristin Sosanie, Tamara Hinton, Kevin Kramp, Bill O'Conner, Nicole Scott, and Jamie Mitchell.

OPENING STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

The CHAIRMAN. The Committee will come to order. We have Members wandering in, but we will get started.

We have three panels today, 15 total witnesses. So good morning and welcome to our second day of hearings on derivative legislation. We have a lot to get to, so I will try to be brief here.

Yesterday, we had a very spirited discussions between Members and witnesses about the issues being considered in the draft legislation. I think that is a good thing and what I intended. We need to have this debate, we need to have it now, and we need to have it out in the open.

It is important that we understand the concerns of those who think we are going too far, and from those who think we are not going far enough. Despite the fact that some of our witnesses yesterday took issue with some sections of the draft bill, I believe the consensus is that we need to take real steps to improve transparency and oversight of derivative markets whether they are on exchanges or over-the-counter.

Today, we will continue the debate with three panels of witness representing financial exchanges, commodity groups, industry groups and investment companies. Since we do have so many witnesses testifying here today, I will ask you all to be brief. Your full written statements will be made part of the record. I welcome you to the Committee and appreciate you taking your time to be with us.

[The prepared statement of Mr. Peterson follows:]

PREPARED STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

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And now, I will to yield to Ranking Member Lucas for any opening remarks he may have today.

The CHAIRMAN. I will now yield to Ranking Member Lucas for any opening remarks that he may have.

OPENING STATEMENT OF HON. FRANK D. LUCAS, A REPRESENTATIVE IN CONGRESS FROM OKLAHOMA

Mr. LUCAS. Thank you, Chairman Peterson.

These hearings will serve as a useful resource for this Committee as we consider the draft legislation you have proposed. It is important that we gather as much information as possible from those who will be impacted by our actions.

No one can argue with the concepts of transparency and accountability. We must make sure that we create responsible legislation that calls for an appropriate level of regulation that respects the nature of the financial marketplace and considers the limits of government intervention.

I appreciate the time and effort that the participants of our three panels have put into today's hearings, and I look forward to your testimony and your answers to the questions posed by our Committee Members.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The chair would request that other Members submit their opening statements for the record so witnesses may begin their testimony to ensure that we have ample time for questions.

We would like to welcome our first panel of witnesses to the table: Mr. Michael Masters, the Managing Member and Portfolio Manager of Masters Capital Management; Mr. Jonathan Short, Senior Vice President and General Counsel of IntercontinentalExchange, Incorporated of Atlanta; Mr. Gary Taylor, CEO of Cargill Cotton, on behalf of the National Cotton Council, American Cotton Shippers and AMCOT in Cordova, Tennessee; Mr. Robert Pickel, Executive Director and CEO of the International

Swaps and Derivatives Association of New York; and the Honorable Joseph Morelle, Chair of New York's State Assembly Standing Committee on Insurance, on behalf of the National Conference of Insurance Legislators from Troy, New York.

The CHAIRMAN. Mr. Masters, we will have you up first.

To all of the witnesses, we appreciate your time; and, Mr. Masters, you can begin.

STATEMENT OF MICHAEL W. MASTERS, FOUNDER AND MANAGING MEMBER/PORTFOLIO MANAGER, MASTERS CAPITAL MANAGEMENT, LLC, ST. CROIX, U.S. VI

Mr. MASTERS. Chairman Peterson and Members of the Committee, thank you for the opportunity to appear before you to discuss this critical piece of legislation. As we witnessed in the last 18 months, what happens on Wall Street can have a huge impact on the average American.

There are three critical elements that must be part of any effective regulatory framework.

First, transparency. Effective regulation requires complete market transparency. In recent years, the big Wall Street banks have preferred to operate in dark markets where regulators are unable to see what is occurring. This limited transparency has enabled them to take on massive amounts of off-balance-sheet leverage, creating what amounts to a shadow financial system. Regulators cannot regulate if they cannot see the whole picture.

Given the speed with which financial markets move, this transparency must be available on a real-time basis. The best way to bring transparency to over-the-counter (OTC) transactions is to make it mandatory for all OTC transactions to clear through an exchange. For that reason, I am very glad to see the sections of this bill that call for exchange clearing. This is a critical prerequisite for effective, regulatory oversight.

The second thing that regulators must do is eliminate systemic risk. A lack of transparency was one of the primary factors in the recent financial meltdown. The other primary factor was the liquidity crisis brought on by excessive leverage at the major financial institutions. One of the most dangerous things about OTC derivatives is that they offer virtually unlimited leverage, since typically no margin is required. This is one of the reasons that Warren Buffett famously called them financial weapons of mass destruction.

By mandating that OTC transactions clear through an exchange, your bill provides for the exchange to become the counterparty to all transactions. Since the exchange requires the posting of substantial margin, the risk to the financial system as a whole is nearly eliminated. When sufficient margin is posted on a daily basis, then potential losses are greatly contained and will prevent a domino effect from occurring.

I do not know the specifics of the clearinghouse that ICE and the major swaps dealers are working to establish, but I would encourage policymakers to look very closely at the amount of margin the swaps dealers were required to post on their trades. If there is a substantial difference between what ICE requires and what CME Group requires, then swaps dealers, in a quest for maximum leverage will flock to the clearing exchange that has the lowest margin requirements.

This is exactly opposite of what regulators and policymakers would want to see. The stronger the margin requirements, the greater will be the mitigation of systemic risk. The weaker the margin requirements, the greater chance we face of another systemic meltdown.

The third thing that regulators must do is eliminate excessive speculation. Speculative position limits are necessary to eliminate excessive speculation and protect us from price bubbles. In commodities, if they had been in place across all commodity derivatives markets, then we would not have seen last year's spike and crash in commodities prices.

The fairest and best way to regulate the commodities derivatives market is to subject all participants to the same regulations and speculative position limits, no matter where they trade. Every speculator should be regulated equally.

The over-the-counter markets are dramatically larger than the futures exchanges. If speculative position limits are not imposed on all OTC commodity derivatives, it would be like locking one's doors to prevent a robbery, while leaving the windows wide open.

This bill needs to include aggregate speculative position limits. If it does not, there is nothing protecting your constituents from another, more damaging bubble in food and prices. Once OTC commodity derivatives are cleared through an exchange, regulators will be able to easily see every trader's position; and the application of speculative limits will be just as simple for over-the-counter as it is for futures exchanges today.

In summary, we have now witnessed how damaging unbridled financial innovation can be. The implosion on Wall Street has destroyed trillions of dollars in retirement savings and has required trillions of dollars in taxpayer money. Fifteen years ago, before the proliferation of OTC derivatives and before regulators become enamored with deregulation, the financial markets stood on a much firmer foundation. It is hard to look back and say that we are better off today than we were then. I think it is clear to everyone in America that this grand experiment, rather than delivering on its great promise, has in fact turned out to be a great disaster.

Thank you.

[The prepared statement of Mr. Masters follows:]

PREPARED STATEMENT OF MICHAEL W. MASTERS, FOUNDER AND MANAGING MEMBER/ PORTFOLIO MANAGER, MASTERS CAPITAL MANAGEMENT, LLC, ST. CROIX, U.S. VI

Chairman Peterson and Members of the Committee, thank you for the opportunity to appear before you today to discuss this critical piece of legislation. As we have witnessed in the last 18 months, what happens on Wall Street can have a huge impact on Main Street. The implosion of Wall Street has destroyed trillions of dollars in retirement savings, has required trillions of dollars in taxpayer money to rescue the system, has cost our economy millions of jobs, and the devastating aftershocks are still being felt. Worst of all, this crisis was completely avoidable. It can be characterized as nothing less than a complete regulatory failure.

The Federal Reserve permitted an alternative, off-balance sheet financial system to form, which allowed money center banks to take on extreme amounts of risky leverage, far beyond the limits of what your typical bank could incur. The Securities and Exchange Commission allowed investment banks to take on the same massive amount of leverage and missed many instances of fraud and abuse, most notably the $50 billion Madoff Ponzi scheme. The Commodities Futures Trading Commission allowed an excessive speculation bubble to occur in commodities that cost Americans more than $110 billion in artificially inflated food and energy prices, which in turn amplified and deepened the housing and banking crises.[1]

Congress appeared oblivious to the impending storm, relying on regulators who, in turn, relied on Wall Street to alert them to any problems. According to the Center for Responsive Politics "the financial sector is far and away the biggest source of campaign contributions to Federal candidates and parties, with insurance companies, securities and investment firms, real estate interests and commercial banks providing the bulk of that money."[2] Clearly, Wall Street was pleased with the return on their investment, as regulation after regulation was softened or removed.

So I thank you today, Mr. Chairman and Members of this Committee for your courageous stand and your desire to re-regulate Wall Street and put the genie back in the bottle once and for all. I share your desire to focus on solutions and ways that we can work together to ensure that this never happens again.

I have included with my written testimony a copy of a report that I am releasing, along with my co-author Adam White, which provides additional evidence and analysis relating to the commodities bubble we experienced in 2008, and the devastating impact it has had on our economy (electronic copies can be downloaded at *www.accidentalhuntbrothers.com*). I would be happy to take questions on the report, but I want to honor your request to speak specifically on this piece of legislation that you are proposing.

I believe that the Derivatives Markets Transparency and Accountability Act of 2009 goes a long way toward rectifying the inherent problems in our current regulatory framework and I commend you for that. While Wall Street will complain that the bill is overreaching, I believe that, on the contrary, there are opportunities to make this bill even stronger in order to achieve the results that this Committee desires.

I am not an attorney and I am not an expert on the Commodity Exchange Act, but I can share with you what I see as the critical elements that must be part of any effective regulatory framework, and we can discuss how the aspects of this bill mesh with those critical elements.

Transparency

Effective regulation requires complete market transparency. Regulators, policymakers, and ultimately the general public must be able to see what is happening in any particular market in order to make informed decisions and in order to carry out their entrusted duties.

In recent years, the big Wall Street banks have preferred to operate in dark markets where regulators are unable to fully see what is occurring. This limited transparency has enabled them to take on massive amounts of off-balance-sheet leverage, creating what amounts to a "shadow financial system."

Operating in dark markets has also allowed the big Wall Street banks to make markets with wide bid-ask spreads, resulting in outsized financial gains for these banks. When a customer does not know what a fair price is for a transaction, then a swaps dealer can take advantage of informational asymmetry to reap extraordinary profits.

Regulators cannot regulate if they cannot see the whole picture. If they are not aware of what is taking place in dark markets, then they cannot do their jobs effectively. Regulators must have complete transparency. Given the speed with which the financial markets move, this transparency, at a minimum, must be available on a daily basis and should ideally be sought on a real-time basis.

The American public, which has suffered greatly because of Wall Street's failures, deserves transparency as well. Individuals should be able to see the positions of all the major players in all markets on a delayed basis, similar to the 13–F filing requirements of money managers in the stock market.

The best way to bring over-the-counter (OTC) transactions out of the darkness and into the light is to make it mandatory for all OTC transactions to clear through an exchange. Nothing creates transparency better than exchange clearing. All other potential solutions, like self-reporting, are suboptimal for providing necessary real-time information to regulators.

For these reasons, I am very glad to see the sections of this bill that call for exchange clearing of all OTC transactions. This is a critical prerequisite for effective

[1] See our newly released report entitled "The 2008 Commodities Bubble: Assessing the Damage to the United States and Its Citizens." Available at *www.accidentalhuntbrothers.com.*

[2] "Finance/Insurance/Real Estate: Background," OpenSecrets.org, Center for Responsive Politics, July 2, 2007. *http://www.opensecrets.org/industries/background.php?cycle=2008&ind=F.*

regulatory oversight. For that reason, it should be a truly rare exception when any segment of the OTC markets is exempted from exchange clearing requirements.

I am further encouraged by sections 3, 4 and 5, which bring transparency to foreign boards of trade and make public reporting of index traders' and swaps dealers' positions a requirement.

Lack of transparency was a primary cause of the recent financial system meltdown. Unsure of who owned what, counterparties assumed the worst and were very reluctant to trade with anyone. The aforementioned provisions in this bill will help ensure the necessary transparency to avoid a crisis of confidence like we just experienced.

Wall Street would much prefer that the OTC markets remain dark and unregulated. They will push to keep as much of their OTC business as possible from being brought out into the light of exchange clearing. They will argue that we should not make major changes to regulation now that the financial system is so perilously weak.

From my perspective this sounds like an intensive care patient that refuses to accept treatment. The system is already on life support. Transparency is the cure that will enable the financial system to recover.

Congress must prioritize the health of the financial system and the economy as a whole above the profits of Wall Street. The profits of Wall Street are a pittance when compared with the cost to America from this financial crisis. We must clear all OTC markets through an exchange to ensure that this current crisis does not recur.

Systemic Risk Elimination

The other primary factor in the meltdown of the financial system was the liquidity crisis, brought on by excessive leverage at the major financial institutions.

By mandating that OTC transactions clear through an exchange, the Derivatives Markets Transparency and Accountability Act of 2009 provides for the exchange to become the counterparty to all transactions. Since the exchange requires the posting of substantial margin, the risk to the financial system as a whole is nearly eliminated. When margin is posted on a daily basis, then potential losses are greatly contained and counterparty risk becomes virtually nil.

To protect its interests, Wall Street will try to water down these measures. The substantial margin requirements will limit leverage, and limits on leverage, in turn, mean limits on profits, not only for banks, but for traders themselves. Because traders are directly compensated with a fraction of the short-term profits that their trading generates, they have a great deal of incentive to use as much leverage as they can to maximize the size of their trading profits. These incentives also exist for managers and executives, who share in the resulting trading profits.

One of the most dangerous things about OTC derivatives is that they offer virtually unlimited leverage, since typically no margin is required. This is one of the reasons that Warren Buffet famously called them "financial weapons of mass destruction."

This extreme over-leveraging is essentially what brought down AIG, which at one time was the largest and most respected insurance company in the world. While by law they could not write a standard life insurance contract without allocating proper reserves, they were able, in off-balance-sheet transactions, to write hundreds of billions of dollars worth of credit default swaps and other derivatives without setting aside any significant amount of reserves to cover potential losses.

If AIG were clearing its credit default swaps through an exchange requiring substantial margin, it would never have required well over $100 billion dollars in taxpayer money to avoid collapsing.

I do not know the specifics of the clearinghouse that the IntercontinentalExchange (ICE) and the major swaps dealers are working to establish but I would encourage policymakers to look very closely at the amount of margin that swaps dealers will be required to post on their trades. If there is a substantial difference between what ICE requires and what CME Group requires then swaps dealers, in a quest for maximum leverage, will flock to the clearing exchange that has lower margin requirements.

This is exactly opposite of what regulators and policymakers would want to see. The stronger the margin requirements, the greater will be the mitigation of systemic risk. The weaker the margin requirements, the greater chance we face of having to bail out more financial institutions in the future.

I strongly urge Congress to resist all pressure from Wall Street to soften any of the provisions of this bill. We must eliminate the "domino effect" in order to protect the system as a whole, and exchange clearing combined with substantial margin requirements is the best way to do that.

Excessive Speculation Elimination

Speculative position limits are necessary in the commodities derivatives markets to eliminate excessive speculation. When there are no limits on speculators, then commodities markets become like capital markets, and commodity price bubbles can result. If adequate and effective speculative position limits had been in place across commodity derivatives markets, then it is likely we would not have seen the meteoric rise of food and energy prices during the first half of 2008, nor the ensuing crash in prices when the bubble burst.

The fairest and best way to regulate the commodities derivatives markets is to subject all participants to the same regulations and speculative position limits regardless of whether they trade on a regulated futures exchange, a foreign board of trade, or in the over-the-counter markets. Every speculator should be regulated equally. If you do not, then you create incentives that will directly favor one trading venue over another.

The over-the-counter (OTC) markets are dramatically larger than the futures exchanges. If speculative position limits are not imposed on all OTC commodity derivatives then there is a gaping hole that speculators can exploit. It would be like locking one's doors to prevent a robbery, while leaving one's windows wide open.

The best solution is to place a speculative position limit that applies in aggregate across all trading venues. Once OTC commodity derivatives are cleared through an exchange, regulators will be able to see every trader's positions and the application of speculative limits will be just as simple for OTC as it is for futures exchanges today.

This type of aggregate speculative position limit is also better than placing individual limits on each venue. For example, placing a 1,000 contract limit on ICE, a 1,000 contract limit on NYMEX and a 1 million barrel (1,000 contract equivalent) limit in the OTC markets will incentivize a trader to spread their trading around to three or more venues, whereas with an aggregate speculative position limit, they can trade in whichever venue fits their needs the best, up to a clear maximum.

I applaud the provisions of your bill that call for the creation of a panel of physical commodity producers and consumers to advise the CFTC on the level of position limits. I believe it affirms three fundamental truths about the commodities derivatives markets: (1) these markets exist for no other purpose than to allow physical commodity producers and consumers to hedge their price risk; (2) the price discovery function is strengthened and made efficient by the trading of the physical hedgers and it is weakened by excessive speculation; and (3) speculators should only be allowed to participate to the extent that they provide enough liquidity to keep the markets functioning properly. Physical commodity producers and consumers can be trusted more than the exchanges or even the CFTC to set position limits at the lowest levels possible while still ensuring sufficient liquidity.

I understand the legal problem with making this panel's decisions binding upon the CFTC. Still, I hope it is clear that this panel's recommendations should be taken very seriously, and if the CFTC chooses to not implement the recommendations they should be required to give an account for that decision. I further believe that the exchanges and speculators should not be part of the panel because they will always favor eliminating or greatly increasing the limits.

CME and ICE may perhaps oppose speculative position limits in general out of a fear that it will hurt their trading volumes and ultimately their profits, but I believe this view is shortsighted. If CME, ICE and OTC markets are all regulated the same, with the same speculative position limits, then trading business will migrate away from the OTC markets and back to the exchanges, because OTC markets will no longer offer an advantage over the exchanges.

I am glad that this bill gives the CFTC the legal authority to impose speculative position limits in the OTC markets, but I openly question whether or not the CFTC will exercise that authority. Like the rest of our current financial market regulators, they have been steeped in deregulation ideology. While I hope that our new Administration will bring new leadership and direction to the CFTC, I fear that there will be resistance to change.

When Congress passed the Commodity Futures Modernization Act of 2000, they brought about the deregulation that has fostered excessive speculation in commodities derivatives trading. Now Congress must make it clear that they consider excessive speculation in the commodities derivatives markets to be a serious problem in all trading venues. Congress must make it clear to the CFTC that they have an affirmative obligation to regulate, and that a critical part of that is the imposition and enforcement of aggregate position limits to prevent excessive speculation.

Summary

We have now witnessed how damaging unbridled financial innovation can be. Wherever there is growing innovation there must also be growing regulation. Substantial regulation is needed now just to catch up with the developments on Wall Street over the last fifteen years.

This bill is ambitious in its scope and its desire to re-regulate the financial markets, and for that I am encouraged. These drastic times call for bold steps, and I am pleased to support your bill. My sincere wish is that it be strengthened and not weakened by adding a provision for aggregate speculative position limits that covers all speculators in all markets equally.

Fifteen years ago, before the proliferation of over-the-counter derivatives and before regulators became enamored with deregulation, the financial markets stood on a much firmer foundation. Today, with all of the financial innovation and the deregulation of the Clinton and Bush years, it is hard to look back and say that the financial markets are better off than they were 15 years ago. I think it is clear to everyone in America that this grand experiment, rather than delivering on its great promise has, in fact, turned out to be a great disaster.

ATTACHMENT

THE 2008 COMMODITIES BUBBLE

Assessing the Damage to The United States and Its Citizens

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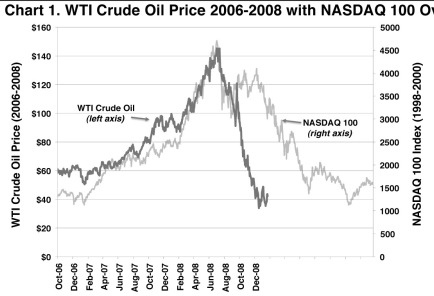
- **The U.S. entered a recession in December 2007. The supply of crude oil increased and the demand for crude oil decreased during the first half of 2008. During this time, crude oil prices defied the recession, defied the laws of supply and demand, and defied gravity by climbing an astonishing 60%, from $90 per barrel in January to $147 per barrel in July.**

- **Beginning in July 2008, the commodities bubble popped and crude oil and other commodities plummeted in price. Crude oil fell by more than $100 per barrel (75%) in just six months. Never before in history has price of crude oil fallen this dramatically.**

Chart 1. WTI Crude Oil Price 2006-2008 with NASDAQ 100 Overlay



Source: Bloomberg

- **The bubble in crude oil, natural gas, and other commodities cost the U.S. more than $110 billion in 2008, which translates to over $846 for every American household. The effect was to take an already weak and frail economy and push it down the stairs.**

- **The commodities bubble amplified the effects of the housing bubble and financial crisis, making them much worse and leading to more bankruptcies, more job losses, and more foreclosures than we would have experienced otherwise.**

- ***This was completely avoidable.* If speculative position limits had been in place across commodities derivatives markets, then there never would have been a commodities bubble in 2008.**

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Special Report ***February 4, 2009***

"You have a generalized commodity bubble due to commodities having become an asset class that institutions use to an increasing extent."

George Soros
One of the most famous and successful hedge fund managers of all time
April 17, 2008 Bloomberg article

"Oil is a huge mania, and it's going to end badly. We've seen it play out hundreds of times over the centuries, and this is no different. It's just the nature of a rip-roaring bull market."

Paul Tudor Jones II
One of the most famous and successful commodities traders of all time
June 2008 edition of Institutional Investor's Alpha Magazine

"You've got speculation in a lot of commodities and that seems to be driving up the price, . . . Movements are dominated by momentum players who predict price changes from Wednesday to Friday on the basis of the price change from Monday to Wednesday."

Dr. Robert Aliber
Distinguished Professor at the University of Chicago
Co-author of "Manias, Panics & Crashes"
June 13, 2008 Bloomberg article

"Commodities followed the euphoria cycle that we had along with housing,"

Robert Schiller
Distinguished Professor at Yale University
Author of "Irrational Exuberance"
October 13, 2008 New York Times article

"This is a market that is basically returning to the price level of a year ago which it arguably should never have left, . . . We pumped up a big bubble, expanded it to an impressive dimension, and now it is popped and we have bubble gum in our hair."

Tim Evans,
Energy Analyst at Citigroup
October 10, 2008 research report

This report is comprised of two parts. Part One discusses new evidence that has emerged which confirms the role of institutional investors in creating the commodities price bubble of 2008. Part Two talks about the devastating impact felt by America and its citizens as a result of the commodities price bubble.

PART ONE – NEW EVIDENCE EMERGES

We released two reports in 2008 that provided strong evidence that institutional investors had been responsible for inflating many commodity prices, including oil. Since those reports were released, we have seen three new and very significant pieces of evidence come to light that conclusively prove that oil and other commodities experienced a price bubble in 2008.

The United States Entered a Recession Prior to 2008

The United States economy is the largest in the world, contributing over 20% of the world's total economic output.[1] We are also the world's largest consumer of energy, with a similar share of the world's total energy consumption.[2] Looking just at oil, the United States consumes approximately 20 million of the 85 million barrels that the world produces each day.[3]

According to the Business Cycle Dating Committee of the National Bureau of Economic Research, the United States officially entered a recession in December of 2007.[4] Real economic output peaked in the fourth quarter of 2007, and began to fall as we entered 2008, marking the beginning of an economic recession.

Given this economic backdrop, oil prices should have been falling rather than rising. What can explain how oil prices could rise by an incredible 60% - from $90 per barrel in January to a peak of $147 per barrel in July - while the world's largest economy and consumer of energy was moving deeper into a recession?

Clearly, oil prices were not responding the way the economic textbooks would expect. Something else was driving the price of crude oil higher.

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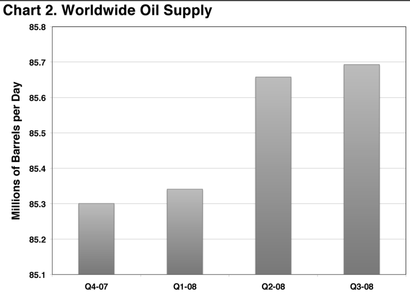
[1] CIA World Factbook based on 2007 estimates. https://www.cia.gov/library/publications/the-world-factbook/index.html
[2] "World Primary Energy Consumption (Btu) 1980-2006," Energy Information Association - United States Department of Energy, December 19, 2008. http://www.eia.doe.gov/pub/international/iealf/tablee1.xls
[3] "World Oil Balance 2004-2008," Energy Information Association - United States Department of Energy, December 19, 2008. http://www.eia.doe.gov/emeu/ipsr/t21.xls
[4] "Determination of the December 2007 Peak in Economic Activity," Business Cycle Dating Committee, National Bureau of Economic Research, November 11, 2008. http://www.nber.org/cycles/dec2008.html

World Oil Supply Was Rising While World Oil Demand Was Falling During the First Half of 2008

Almost every explanation proffered by anti-bubble theorists for oil's dramatic rise in the first half of 2008 focused on the supply and demand for oil. But we now have hard data that proves that the world supply of oil was actually rising while the world demand for oil was falling in the first half of 2008.

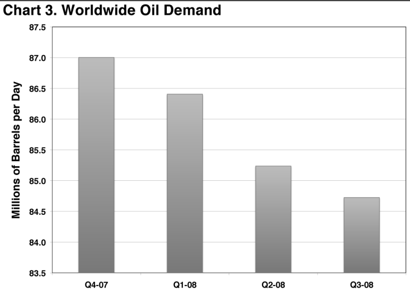
Chart 2. Worldwide Oil Supply



Source: Energy Information Administration, U.S. Department of Energy, "World Oil Balance 2004-2008," January 13, 2009.

The Energy Information Administration (a department within the United States Department of Energy) has released figures for world oil supply and demand. These figures (depicted in Chart 2 above) show that world oil production rose in the first quarter of 2008 and rose again in the second quarter of 2008. At the same time, as Chart 3 below shows, world oil consumption fell in the first quarter of 2008 and fell again in the second quarter of 2008.

Chart 3. Worldwide Oil Demand



Source: Energy Information Administration, U.S. Department of Energy, "World Oil Balance 2004-2008," January 13, 2009.

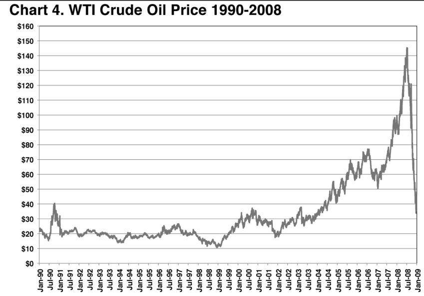
With supply increasing and demand decreasing, economic textbooks would predict that prices would fall substantially. How, then, can we explain the spike in the price of crude oil?

It was easier to theorize that the oil price spike was a function of supply and demand when there were no supply and demand figures to reference. But now that the EIA has released the supply and demand figures, we know that they cannot explain the price increase. Oil prices in the first half of 2008 defied a recession, defied the laws of supply and demand and defied gravity with their meteoric rise.

The Crash in Oil Prices Reveals Oil Was a Bubble

The recent crash in oil prices from a high of $147 to a low of $33 in less than 6 months is the greatest evidence that oil prices were grossly inflated at the peak. Never before in history have we seen a $100 drop in oil prices. Never before in history have we seen a 75% drop in oil prices in such a short period of time.

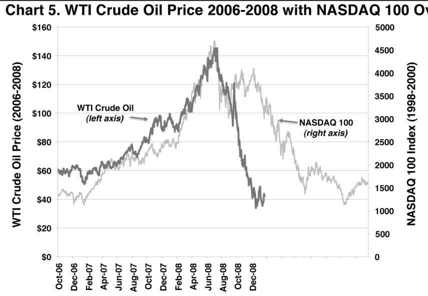
Chart 4. WTI Crude Oil Price 1990-2008



Source: Bloomberg

In the capital markets, where bubbles are commonplace, most oil watchers will privately agree that oil and other commodities experienced a bubble that finally popped in 2008. In Chart 5 we compare the bubble in oil to one of the most famous bubbles – the Internet / Tech Bubble of 1998-2000. As you can see, the Oil bubble expanded nearly as much as the Tech bubble, and burst much more violently.

Chart 5. WTI Crude Oil Price 2006-2008 with NASDAQ 100 Overlay



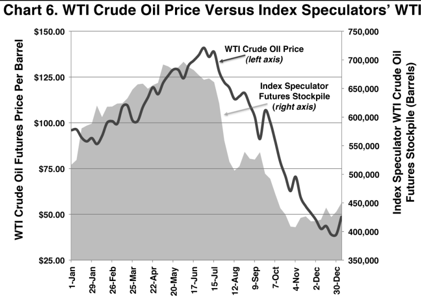
Source: Bloomberg

The Best and Simplest Explanation for the Oil Bubble Is the Flow of Speculative Money into and out of Crude Oil Futures

We have continued to track the flow of Index Speculator money into and out of crude oil futures through the end of 2008. In the first six months of 2008, Index Speculators poured between $50 and $60 billion into commodity indices such as the S&P-GSCI and the DJ-AIG, raising total investment from approximately $178 billion in January to $317 billion in July. This resulted in the buying of between 130 and 170 million barrels of WTI crude oil in the futures markets, and raising Index Speculators' stockpile of crude oil futures from approximately 517 million barrels to 665 million barrels. We believe this was the primary factor driving the rise of crude oil prices from $90 in January to $140 at the end of June.

In July, Index Speculators began to pull money out of commodity indices causing the bubble to burst. In the last six months of 2008, we estimate that between $60 and $80 billion flowed out of these trades causing total investment to fall from $317 billion in July to approximately $87 billion at the end of December. This resulted in the selling of between 220 and 240 million barrels of crude oil in the futures markets, and taking Index Speculators' stockpile of crude oil futures from 665 million barrels in July down to 435 million barrels by the end of December. This selling on the part of Index Speculators, combined with the de-leveraging of hedge funds and other traditional speculators, were two of the major factors behind oil's historic crash from $140 to $40.

Chart 6. WTI Crude Oil Price Versus Index Speculators' WTI Crude Futures Stockpile



Source: Bloomberg, Standard & Poors, Dow Jones, calculations based upon Commodities Futures Trading Commission's COT/CIT report

Chart 6 shows the price of crude oil graphed against Index Speculators' stockpile of crude oil futures expressed in barrels. One can see that as Index Speculators were buying large amounts of crude oil futures and increasing their stockpile, the price of crude oil was rising. As they were selling large amounts of crude oil futures and reducing their stockpile, the price of crude oil was falling. The buying and selling by Index Speculators correlates closely with the rise and fall of crude oil prices. In contrast with explanations offered by others, this is the only one that correlates with the facts.

PART TWO – ASSESSING THE DAMAGE

We have experienced the first bubble in commodity prices since the Commodity Exchange Act was passed in 1936. This historic price bubble was made possible by the deregulation of the commodities derivatives markets and the effective elimination of speculative position limits.

Commodity price bubbles are much more devastating than asset price bubbles. While asset price bubbles are expanding, people feel good about the fact that their paper wealth is increasing. But commodities are not assets; they are raw materials consumed by each and every person on the planet. So as commodity price bubbles expand and prices rise dramatically, the negative impact is felt by every human being around the globe.

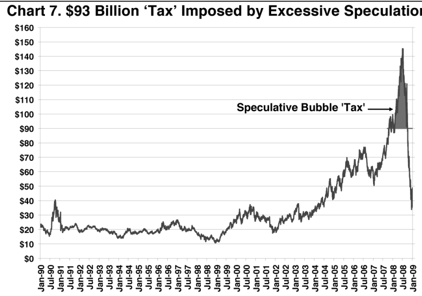
The 2008 commodities bubble has now burst, leaving in its wake a devastating impact on the world economy. We must assess the true cost of this commodities bubble so that society might resolve to never let this happen again.

The Oil & Gas Bubbles Cost Americans More Than $110 Billion

The oil bubble could not have peaked at a worse time for the American economy. We now know that the United States was already entering a recession as 2008 began. The average oil price in the fourth quarter of 2007 was $90.50, and oil started the year in the low to mid $90s. As supply was rising and demand was dropping, the price of oil should have been falling instead of rising.

It is our strong belief that every dollar above $90 per barrel represented a "tax" imposed by excessive speculation upon oil consumers (see Chart 7 below). Ed Morse, former oil analyst at Lehman Brothers (now with Louis Capital Markets), was recently quoted saying essentially the same thing: "the move above $90 a barrel was driven by financial flows rather than fundamentals" of supply and demand."[5]

Chart 7. $93 Billion 'Tax' Imposed by Excessive Speculation in Oil



Source: Bloomberg, author estimates

[5] "OPEC Calls for Curbing Oil Speculation, Blames Funds (Update2)," Maher Chmaytelli, Bloomberg News, January 28, 2009.
http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a44ddDuoFSe8

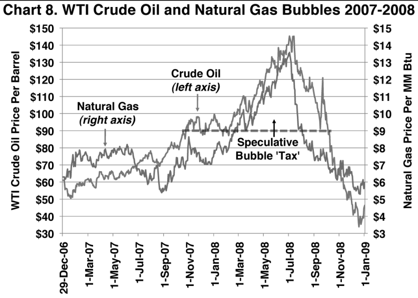
This is a conservative statement to make, considering that oil experts have consistently estimated that oil's marginal cost of production ranged from $60 to $75 per barrel in 2008.[6] With oil around $40 per barrel today, even a $90 per barrel price seems grossly inflated. It is hard enough to come up with a rational explanation for $90 per barrel, let alone $147.

If we seek to quantify the direct cost to Americans from the oil bubble, it is fair to say that every dollar spent over $90 per barrel was an unnecessary "tax" imposed by excessive speculation. Let's begin with the fact that Americans consume 20 million barrels of oil per day. If we calculate the daily premium above $90 and multiply it times this figure, we can arrive at how much the oil bubble directly cost Americans. By our calculations, we estimate the direct cost of the oil bubble to be $93 billion. The direct cost to the world was approximately $393 billion.

If we had chosen a less conservative and more realistic assumption by considering anything over $75 per barrel to be excessive then the total cost to America would be $170 billion just from the oil bubble, with a cost to the world of $724 billion.

Turning to natural gas, we believe that every penny over $9 per thousand cubic feet can be attributed to excessive speculation. Chart 8 below shows that natural gas has historically traded around one-tenth the price of crude oil and that both commodities experienced a bubble in 2008. By our calculations, we conservatively estimate the direct cost of the natural gas bubble to be $17 billion. Combined with crude oil the cost of these two bubbles was $110 billion. That means the average American household was forced to pay $846 more for energy in the first half of 2008 because of excessive speculation.

Chart 8. WTI Crude Oil and Natural Gas Bubbles 2007-2008



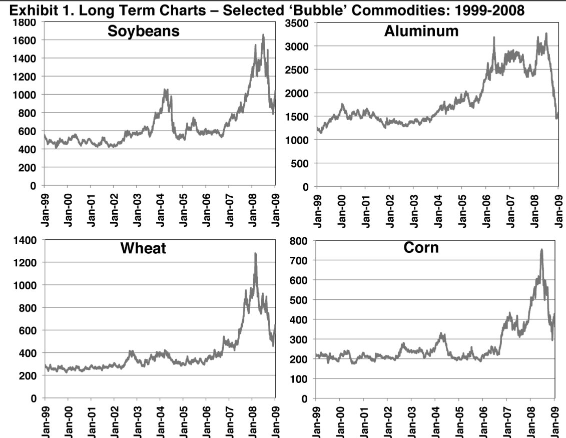
Source: Bloomberg, author estimates

This figure only represents the direct cost of excessively high energy prices. It does not attempt to estimate any of the economic multiplier effects that result from such a large "tax" being imposed. It also does not take into account the bubbles in other commodity prices.

[6] "Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation? – Part II," House Energy Committee, Subcommittee on Oversight and Investigations, June 23, 2008. http://energycommerce.house.gov/cmte_mtgs/110-oi-hrg.062308.EnergySpec.shtml

While we have not performed the same in-depth supply and demand analysis for other commodities to assess the cost of excessive speculation, simply looking at their long term charts in Exhibit 1 shows that many commodities experienced bubbles that popped in 2008.

Exhibit 1. Long Term Charts – Selected 'Bubble' Commodities: 1999-2008



Source: Bloomberg

The fact that unrelated commodities such as aluminum, soybeans and natural gas all demonstrate very similar price patterns is further proof that Index Speculators and other institutional investors have been driving commodities prices. While we cannot put a price tag on the cost to America of these inflated prices across all commodities we are confident that the total cost to Americans from the commodities bubble easily exceeds $110 billion.

In our new world of trillion dollar Wall Street bailouts, $110 billion does not seem as shocking as it once did, but this number must be put it in perspective. The U.S. Congress and President Bush passed the Economic Stimulus Act of 2008 in February of last year. It called for tax rebates of between $300 and $600 per person.[7] By the time this stimulus finally reached the average American, the high cost of energy and food prices had nearly canceled out the entire economic benefit of the bill. At that point, the Stimulus bill simply helped Americans pay the "excessive speculation tax" levied on energy and other commodities.

[7] http://en.wikipedia.org/wiki/Economic_Stimulus_Act_of_2008

The Commodities Bubble Inflicted Pain on American Businesses

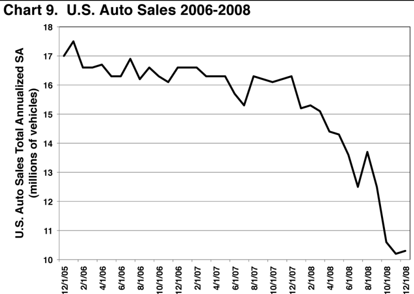
High energy costs made almost everything in America more expensive. It takes energy to produce goods, and it takes energy to transport them through the supply chain. Petroleum is the basis for petrochemicals such as plastic, so the cost of packaging for most goods increased as well.

A single company, Proctor & Gamble, experienced annual cost increases of $2 billion due to high energy costs.[8] Dow Chemicals, one of the largest petrochemical manufacturers, was forced to announce an across-the-board 20% price increase for all of their products.[9]

These companies were actually the fortunate ones. Many companies that are more directly impacted by rising fuel costs, such as airlines and trucking companies, were forced into bankruptcy. Many retailers were also forced to go out of business because high food and energy prices led to weak demand for non-essential goods. Against this backdrop of flat to weakening retail prices, many retailers could simply not absorb the rising costs.

For the U.S. Auto Industry, which directly and indirectly employs approximately 2.1 million Americans, the oil bubble was a crushing blow that might yet prove to be fatal.[10] With astronomically high gas prices, consumer preferences shifted away from SUVs, trucks and other "gas guzzlers" to smaller, lighter, more fuel-efficient cars, and as a result, Detroit suffered huge declines in car sales.

Chart 9. U.S. Auto Sales 2006-2008



Source: Bloomberg

The Commodities Bubble Led to Increased Unemployment

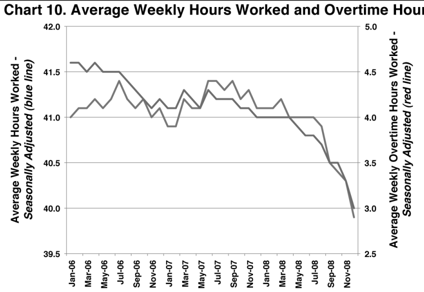
As American consumers were forced to spend dramatically more on food and energy, they were forced to cut back spending on non-essential items. Facing weakening demand, businesses were squeezed between rapidly escalating raw materials and

[8] "Oil Prices Raise Cost of Making a Range of Goods," Louis Uchitelle, New York Times, June 8, 2008. http://www.nytimes.com/2008/06/08/business/08oil.html?_r=1
[9] ibid.
[10] "One in 10 jobs Tied to Autos? Not so Fast," Russell Goldman, ABC News, December 19, 2008. http://abcnews.go.com/Business/story?id=6491455&page=1

transportation costs on the one side, and weak or no pricing power on the other. While their costs were going up, their revenues were stagnant or declining.

Many businesses went bankrupt, and most that were able to stay in business were forced to cut workers' hours or lay them off completely. This, of course, fed a vicious cycle that continues to play itself out in the economy today.

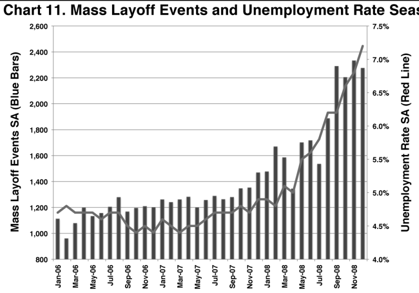
Chart 10. Average Weekly Hours Worked and Overtime Hours Worked SA 2006-2008



Source: Bureau of Labor Statistics

Chart 10 above shows that average weekly hours worked has been dropping since mid-2007. Not coincidentally, oil prices doubled from mid-2007 to mid-2008. Chart 11 below shows the number of mass layoff events along with the unemployment rate. Again, one can see that layoffs and unemployment began to rise in earnest in mid-2007 and have continued to increase since then.

Chart 11. Mass Layoff Events and Unemployment Rate Seasonally Adjusted



Source: Bureau of Labor Statistics

The Commodities Bubble Made the Banking Crisis Much Worse

Because of the commodities bubble, Americans were forced to pay dramatically more for food and energy, leaving them with less money to use to pay their debts. Many were faced with the grim choice between filling up their gas tanks and feeding their families or making their debt payments.

Looking at quotations by James Chessen, the Chief Economist of the American Bankers Association, one can clearly see the role that high food and energy prices played in debt delinquencies.

"No relief for consumers is in sight as food and gas prices remain stubbornly high and income growth is anemic."[11]
- Q4-07 comments on delinquencies

"It was a tough quarter for some people. . . . Faced with rising food and gas prices and little income growth, fewer resources have been available to manage debt."[12]
- Q1-08 comments on delinquencies

"The tax stimulus is helping to boost personal income, but persistently high gas and food prices will eat away at overall resources."[13]
- Q2-08 comments on delinquencies

In addition to the direct tradeoffs between paying for food and energy versus paying down debts, there was also a disturbing trend in 2008 that was widely reported: consumers opted to pay their credit cards bills rather than make their home mortgage payments. One credit counselor described it this way "Their homes are at risk, and they know it. But people say, 'I don't want to let my credit cards go because that's my cash flow.' "[14] Many people were forced to rely on credit cards to purchase the gas and groceries that they needed, even if it meant risking losing their house to foreclosure.

The Commodities Bubble Made the Housing Crisis Much Worse

We discussed how inflated food and gas prices made it more difficult for people to make their mortgage payments, and how some of those people lost their homes to foreclosure, which put downward pressure on home prices. But that is not the only way high gas prices affected home prices and new home construction.

A study by Joe Cortright, an economist with the non-profit "CEOs for Cities," published a white paper entitled "Driven to the Brink: How the Gas Price Spike

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[11] "Consumer Delinquencies Up In Fourth Quarter," American Bankers Association press release, April 3, 2008.
http://www.aba.com/Press+Room/040308ConsumerDelinquencyBulletin.htm
[12] "Weak Economy Pushes Consumer Delinquencies Higher in First Quarter," American Bankers Association press release, July 2, 2008.
http://www.aba.com/Press+Room/070208DelinquenciesFirstQuarter08.htm
[13] ibid.
[14] "More Americans Using Credit Cards To Stay Afloat," Kathy Chu, USA Today, March 30, 2008. http://www.usatoday.com/money/perfi/credit/2008-02-28-credit-cards_N.htm

Popped the Housing Bubble and Devalued the Suburbs."[15] In the report, he presents very compelling data that shows that as gas prices rose dramatically, so did the transportation costs for families living in the suburbs and exurbs. This made living in the 'burbs much less desirable, reducing the demand for homes, and causing home prices to drop. Since most of the new home construction was taking place in the 'burbs, high gas prices undermined the demand for new home construction and contributed to the housing crisis.

Summary

The bursting of the housing bubble and the financial meltdown of Wall Street have had huge negative effects on our economy. Those effects would have been very painful for America even if there had been no bubble in commodities prices. Knowing that the commodities bubble directly cost Americans at least $110 billion, and understanding that there were many indirect costs as well, we know that it made our present situation dramatically worse. The commodities bubble had the effect of taking a weak and frail economy and pushing it down the stairs.

The extreme volatility that we have seen in commodity prices has been unprecedented in history. This volatility is bad for consumers and producers alike. No one has escaped the damage that this bubble has inflicted.

There is no way to know how our economy would have been performed if there were no commodities bubble in 2008. Perhaps we would have endured a Category 3 storm instead of the Category 5 we are experiencing today.

We do know this: the commodities bubble was completely preventable. If Congress will take action to impose speculative position limits across all commodities derivatives markets, then we can be assured that it will never happen again.

[15] "Driven to the Brink: How the Gas Price Spike Popped the Housing Bubble and Devalued the Suburbs," Joe Cortright, CEOs for Cities, May 2008.
http://www.ceosforcities.org/newsroom/pr/files/Driven%20to%20the%20Brink%20FINAL.pdf

The CHAIRMAN. Thank you very much, Mr. Masters. We appreciate your being with us.

Next, we will have Mr. Short from ICE, welcome to the Committee.

STATEMENT OF JOHNATHAN H. SHORT, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, INTERCONTINENTALEXCHANGE, INC., ATLANTA, GA

Mr. SHORT. Thank you.

Chairman Peterson, Ranking Member Lucas, I am Johnathan Short, Senior Vice President and General Counsel with IntercontinentalExchange or ICE. We are grateful for the opportunity to provide comments on the discussion draft of the Derivatives Markets Transparency and Accountability Act, and I fully support the goals of the Act to bring transparency and accountability to commodity markets.

As the owner of regulated exchanges and clearinghouses in the United States, the United Kingdom and Canada, ICE has committed to facilitating global regulatory cooperation to ensure that regulatory best practices are adopted around the world. As the global nature of this financial crisis aptly illustrates, systemic market problems cannot be solved unilaterally, and solutions will require close cooperation between governments of major developed nations and a willingness on the part of those governments to implement the best financial market practices, regardless of their source of origin. Combined with commitment to open markets, such an approach will be the best way to achieve the goals of the DMTAA.

Against this backdrop, we would offer brief thoughts on three sections of the Act: section 3, foreign boards of trade; section 6, trading limits to prevent excessive speculation; and section 16, limitation on the ability to purchase credit default swaps. Please note that our views on specific provisions of the Act should not be misconstrued as opposition to the Act as a whole, or opposition to the important steps that this Committee has taken to restore confidence in our financial markets.

Beginning with section 3 on foreign boards of trade, ICE is generally supportive of this provision as it codifies existing obligations that ICE Futures Europe has been complying with since late last year, including implementation of position limits and accountability for DCM link contracts. And, for the first time in a European exchange regulation, the generation of large trader reporting to assist the CFTC in its markets surveillance efforts.

However, section 3 of the Act contains one provision that would inappropriately discriminate against foreign exchanges and the competition that they bring to bear. Unlike the requirements applicable to domestic exchanges, section 3 requires that foreign exchanges adopt position limits taking into consideration the relative sizes of respective markets. This provision would hamper competition between exchanges and would effectively prevent foreign exchanges from attaining sufficient market liquidity to offer the type of trading markets necessary to compete with domestic exchanges as all competitors would, by definition, start with little or no market share. Domestic exchanges could ultimately be impacted as well by this provision if foreign governments adopt similar provisions in their laws.

Considering the significant benefits that competition has brought to the marketplace and the need for international regulatory cooperation, we would respectfully request that this provision of the Act be modified, and would note that if the goal of the provision is to prevent multiplication of positions across numerous exchanges, the same goal could be achieved through requiring market participants to liquidate positions should they exceed an aggregate limit observed by the CFTC.

Turning to section 6 of the Act, ICE's subsidiary, ICE Futures U.S., formerly the New York Board of Trade, is a designated contract market regulated by the CFTC. Among the products it lists for trading are three international soft commodity contracts: coffee, wool, sugar and cocoa; and it is the preeminent market for price discovery in these commodities. None of these commodities are grown in the United States or are subject to any domestic price support programs, unlike domestic commodities'; and all of these commodities are also traded on established exchanges in London, Brazil and the Far East.

Section 6 fails to distinguish between the international agricultural commodities and domestically grown agricultural commodities that have traditionally been the focus of the Committee's oversight. Section 6 would require the CFTC, rather than ICE Futures U.S., to set position limits with respect to these international markets, and would replace ICE Futures' strong market expertise in these areas to the detriment of both the exchange and the broader markets, potentially shifting trading in these commodities to foreign markets that are not subject to CFTC jurisdiction.

Finally, turning to section 16 of the Act that prohibits trading and credit default swaps without ownership and the underlying obligation. As with all trading markets, hedgers must be able to transact with another party willing to buy their risk for a price. Section 16 would likely end the CDS market in the United States due to the inability of hedgers to find counterparties legally able to buy their risk, and could prove problematic for the trading of CDS indices in which parties would apparently have to own all of the underlying bonds to trade an index. This would be counterproductive, as transparent and stable CDS markets are important for the recovery of broader financial markets.

Many of the problems that have been identified in the CDS market relate to the lack of transparency in markets and outsize risks undertaken by financial entities, and we believe that these issues can be addressed through central counterparty clearing. ICE is proud to be working towards establishing ICE U.S. Trust to clear these products.

In conclusion, ICE strongly supports the goals of the Act and will continue to work cooperatively with this Committee to find solutions that promote the best marketplace possible.

[The prepared statement of Mr. Short follows:]

PREPARED STATEMENT OF JOHNATHAN H. SHORT, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, INTERCONTINENTALEXCHANGE, INC., ATLANTA, GA

Introduction

Chairman Peterson, Ranking Member Lucas, I am Johnathan Short, Senior Vice President and General Counsel of IntercontinentalExchange, Inc., or "ICE." We are grateful for the opportunity to provide comments on the "discussion draft" of the Derivatives Markets Transparency and Accountability Act (DMTAA).

ICE fully supports the goal of the DMTAA to "bring transparency and accountability to commodity markets." Over the past decade, we have worked with regulators both in the United States and abroad to achieve this end and appreciate the opportunity to work on additional improvements.

As background, ICE operates three regulated futures exchanges: ICE Futures Europe, formerly known as the "International Petroleum Exchange," is regulated by the U.K. Financial Services Authority (FSA). ICE Futures U.S., previously known as "The Board of Trade of the City of New York (NYBOT)" and the New York Clearing Corporation are both regulated by the CFTC. ICE Futures Canada, which was previously called the Winnipeg Commodity Exchange, is regulated the Manitoba Securities Commission. In addition, ICE operates an over-the-counter (OTC) energy platform as exempt commercial market, as defined by the Commodity Exchange Act. On these exchanges, ICE offers futures and options contracts on energy products (including the benchmark Brent and WTI contracts), agricultural commodities, currencies and equity indexes.

ICE has worked to provide transparency to a varied array of markets. For example, ICE brought transparency to OTC energy markets nearly a decade ago, with a digital platform that transformed the marketplace from an opaque, telephone-based network of brokerages to a global market with real-time prices on electronic trading screens. In its *2007 State of the Markets Report,* Federal Energy Regulatory Commission (FERC) observed that ICE "provides the clearest view we have into bilateral spot markets." [1]

In 2002, in response to the credit and counterparty risk crisis that were then gripping the energy markets, we introduced clearing into the OTC energy markets. Cleared contracts now account for more than 90 percent of ICE's OTC business. Believing that centralized clearing is an essential next step in stabilizing the credit derivatives market, since last summer ICE has been working with the Federal Reserve System, the New York Banking Department and a number of industry participants to develop a clearing solution for credit default swaps (CDS).

Last May, as part of the farm bill reauthorization, Congress provided the CFTC with greater oversight of electronic OTC markets, or Exempt Commercial Markets. The new law provides legal and regulatory parity between fully regulated futures exchanges and OTC contracts that serve a significant price discovery function,[2] while also recognizing and preserving the role of OTC markets in providing innovation and customization. ICE supported this legislation, and we remain grateful for this Committee's leadership during that debate.

Because ICE operates markets in both domestic and foreign jurisdictions, ICE is keenly aware of the global nature of most commodity and financial derivative markets. Furthermore, ICE is committed to facilitating global regulatory cooperation and the implementation of best practices in financial markets around the world. As the global nature of this financial crisis illustrates, systemic market problems cannot be solved independently, and solutions will require both close coordination and cooperation between governments of major developed nations and a willingness to implement best practices regardless of their source of origin. Combined with a commitment to open markets, such an approach will be the best way forward toward solving the problems that have impacted economies around the world.

We offer our comments on several provisions in the bill in the spirit of finding solutions that will achieve the stated purpose of improving transparency and accountability in commodity markets.

Section 3—Foreign Boards of Trade

Earlier last month, the G30's Working Group on Financial Reform, led by Chairman Paul Volcker, published its Framework for Financial Stability. Core recommendation two states, "The quality and effectiveness of prudential regulation and supervision must be improved. This will require better-resourced prudential regu-

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[1] Federal Energy Regulatory Commission, *2007 State of the Markets Report,* pg. 9 (Issued, March 20, 2008).

[2] This provision of the farm bill is commonly referred to as the "Closing the Enron Loophole Act."

lators and central banks operating within structures that afford much higher levels of national and international policy coordination.'' Recommendation 6b, on regulatory structure, states, ''In all cases, countries should explicitly reaffirm the insulation of national regulatory authorities from political and market pressures and reassess the need for improving the quality and adequacy of resources available to such authorities.''

By supporting coordination and information sharing among international regulators, the foreign board of trade provision in the DMTAA, advances the G30's recommendations. We are concerned; however, that one aspect of that provision could limit competition between domestic and foreign exchanges and ultimately threaten cooperation between domestic and foreign regulators, and indeed domestic and foreign governments, in implementing uniform standards to improve markets.

Since 2006, ICE has worked with the United Kingdom's Financial Services Authority to provide the CFTC with visibility into markets traded on its foreign board of trade to allow the CFTC to properly surveil domestic regulated markets. On June 17, 2008, the CFTC revised the conditions under which ICE Futures Europe operates in the United States by amending the ''no-action relief letter'' that permits that exchange to have direct access to U.S. customers for its WTI Crude Oil Futures Contract. The amended letter conditioned ICE Futures Europe's direct screen based access on the adoption of U.S. equivalent position limits and accountability levels, together with reporting obligations, related to contracts that are linked to the price of a U.S. designated contract market price. Since October, ICE Futures Europe has been complying with the revised No Action letter.

Section 3 of the DMTAA essentially codifies the conditions set forth in the CFTC's revised No Action letter for ICE Futures Europe, with one important exception. Unlike the requirements applicable to domestic exchanges, section 3 requires foreign exchanges to adopt position limits for the affected contract taking ''*into consideration the relative sizes of the respective markets*''. This provision discriminates against foreign exchanges, and would effectively prevent them from attaining sufficient market liquidity to compete with domestic exchanges as all competitors would by definition start out with little or no market share. In addition, domestic exchanges could be impacted through the adoption of similar provisions of law in foreign countries which have a larger relative share of the underlying commodity market.

In recent years, the only effective competition in the futures industry has come from foreign exchanges and exempt commercial markets. That competition has led U.S. exchanges to transition markets to transparent electronic trading, with full audit trails and improved risk management through straight through processing. It has also resulted in more efficient markets bringing about many benefits for market participants such as lower trading costs and tighter bid/ask spreads. With one exchange in control of more than 97 percent of U.S. futures market, competition is more important than ever. Requiring foreign markets to set position limits according to respective market size would effectively bar foreign exchanges from competing in the U.S., would likely be viewed was extraterritorial regulation by foreign market regulators, and would be inconsistent with the higher level of international policy coordination contemplated by the G30 policy recommendations. ICE respectfully requests that this particular provision of section 3 be reconsidered for the broader policy goals that are sought to be achieved by the G30 policy recommendations and in recognition of the fact that no single piece of legislation adopted here or elsewhere will achieve its ends unless appropriate standards are adopted on an international basis.

Section 6—Trading Limits To Prevent Excessive Speculation

ICE's U.S. subsidiary, ICE Futures U.S. (formerly the New York Board of Trade) is a designated contract market regulated by the CFTC. Among the products it lists for trading are three international soft commodities—coffee, world sugar and cocoa—and it is the pre-eminent market for price discovery of these commodities. None of these commodities is grown in the United States or is subject to domestic price support programs. Moreover, none of them was the subject of hearings last year conducted by Congressional Committees or reviews by the CFTC into the rise and fall of certain commodity prices. Because they are liquid contracts traded on a designated contract market, our futures and options contracts in these commodities have been subject to position accountability levels and spot month position limits that have been established and administered by the Exchange for more than a decade without incident. Under the terms of the standardized futures contracts, ICE Futures U.S. also regulates physical delivery of those three international commodities from ports or warehouses located in more than two dozen foreign countries around the world.

Section 6 of the proposed legislation fails to distinguish between ICE's international agricultural contracts and the domestically-grown agricultural commodities that we believe were the bill's intended subjects. Specifically, the legislation would require the CFTC to set position limits on the number of futures and option contracts that a person could hold in any one futures month of a commodity, in all combined futures months of a commodity, and in the spot month. In contrast, ICE Futures U.S. sets limits for its coffee, sugar and cocoa contracts based on its extensive experience with these markets.

In addition, the proposed legislation would amend the Commodity Exchange Act core principles applicable to designated contract markets like ICE Futures U.S. by eliminating the availability of "position accountability" levels for speculators in international agricultural commodities. As noted previously, ICE Futures U.S. has set and administered position accountability levels in its internationally-based products for over a decade. For example, through its market oversight, ICE Futures U.S. has been able to respond to market conditions and the needs of its users in a flexible manner, while maintaining transparent and liquid markets relied upon throughout the world. This provision, if implemented, would replace ICE Futures U.S.'s strong market surveillance role with an inflexible regime that would be established, and possibly administered, by the CFTC. This could very well drive business to London, Brazil and the Far East where these products already trade on established futures markets. We do not believe this was the drafters' intent.

Section 6—Limitations on index traders

Section 6 defines *bona fide* hedging in a way that would prohibit index traders from taking a position in excess of position limits. This would be a significant change in market structure and will have an immediate and deleterious impact. A recent market study performed by Informa examined the impact of index funds on market volatility. The study employed both Granger causality and vector auto-regression tests and determined ***that there was no link between index funds and market volatility.*** Greatly reducing the participation of index funds in the market would be disadvantageous to the market at-large and would most likely only benefit the very largest participants in a given market. In a soft commodities market (*e.g.,* coffee, sugar or cocoa), the removal of this additional liquidity could potentially enable a single large entity or a small group of entities to wield considerable influence on the market dynamics.

Section 9 requires the CFTC to study the impact of commodity "fungibility" and whether there should be "aggregate" position limits for similar agriculture or energy contracts traded on DCMs, DTEFs, 2(g) and 2(h) markets. Sec. 10 requires a GAO study of international regulation of energy commodity markets. Both reports are due in a year. ICE supports these studies without reservation, and we believe this legislation would be improved if it were informed by equally thorough reports on the issues we have discussed today.

Section 16—Limitation on Ability To Purchase Credit Default Swaps

Section 16 of the bill would prohibit trading in credit default swaps without ownership of the underlying reference obligation. This provision is problematic on several levels.

First, CDS perform an important market function in allowing parties to hedge credit risk. Section 16 is titled "Limitation on Eligibility to Purchase a Credit Default Swap." However, the language in subsection (a) prohibits parties from "entering into a credit default swap" unless they own the underlying bonds. As with all trading markets, another party must be willing to assume the hedger's risk; therefore, section 16 would likely end the CDS market in the United States due to the inability of hedgers to find counterparties legally able to "buy their risk". This would be counterproductive, as a transparent and stable CDS market is important for the recovery of financial markets. Furthermore, not all credit risk has a tailored credit default swap. Section 16 would prohibit parties from hedging default exposure by purchasing credit default indices, unless the party owned every underlying bond in the index.

Second, ICE believes that the goals of transparency and mitigation of counterparty credit risk and systemic risk can be achieved through central clearing of CDS and through resulting public and regulatory transparency. Section 16 would run counter to this goal as it would impair the liquidity needed to efficiently manage risk within a clearinghouse in the event of a default or similar event. ICE respectfully requests that the Committee consider eliminating this provision of the draft bill.

During the financial crisis, as cash markets evaporated, and markets for commercial paper, corporate bonds and other debt instruments dried up, the CDS market has remained liquid, offering lenders and investors a way to hedge risk and—just as important—a market-based, early-warning price discovery function. Broader availability of credit protection can encourage sovereign and corporate lending. As lenders and investors consider ways to improve credit risk evaluations, CDS spreads have proven to be more reliable indicators of an institution's financial health than credit agency ratings.

Finally, on the note of global cooperation, last week in Davos, E.U. Financial Services Commissioner Charlie McCreevy said he would not support a ban on trading credit default swaps unless the party held a position in the underlying bonds. Prohibiting this trade in the United States will almost certainly lead to a wholesale migration of the CDS marketplace overseas, outside the reach of U.S. regulators and this Committee. We do not believe that is the intent of this legislation.

Conclusion

ICE is a strong proponent of open and competitive derivatives markets, and of appropriate regulatory oversight of those markets. As an operator of global futures and OTC markets, and as a publicly-held company, we understand the essential role of trust and confidence in our markets. To that end, we are pleased to work with Congress to address the challenges presented by derivatives markets, and we will continue to work cooperatively for solutions that promote the best marketplace possible.

Mr. Chairman, thank you for the opportunity to share our views with you. I am happy to answer any questions you may have.

The CHAIRMAN. Thank you, Mr. Short. I thank you for being with the Committee.

Mr. Taylor, welcome to the Committee.

STATEMENT OF GARY W. TAYLOR, CEO, CARGILL COTTON COMPANY, CORDOVA, TN; ON BEHALF OF NATIONAL COTTON COUNCIL; AMERICAN COTTON SHIPPERS ASSOCIATION; AND AMCOT

Mr. TAYLOR. Thank you.

Thank you, Chairman Peterson, Ranking Member Lucas, and Members of the Committee. I am Gary Taylor, CEO of Cargill Cotton in Memphis, Tennessee; and I appear today here representing the members of the National Cotton Council, the American Cotton Shippers and AMCOT, which is a trade association of marketing cooperatives.

In the past year, the cotton industry has undergone severe financial strain due to the unpredictable risk caused by a dysfunctional futures market. The March 2008, debacle and the ICE No. 2 Cotton Contract forced a number of first handlers into bankruptcy, while others have announced orderly closures.

Traditional merchandising relationships have ceased, because price risks are too great for hedging purposes. Growers continue to be concerned about the financial viability of marketing entities with whom they have previously contracted.

To ensure the survival of our marketing structure, the cotton futures market must be returned to its historical function of price discovery and risk management relative to real market conditions.

As the cotton industry informed this Committee in 2008, investment funds and over-the-counter operatives flooded our futures markets with record amounts of cash. In our opinion, their presence distorted both the futures and physical markets. We believe the legislation before the Committee, the Derivatives Markets Transparency and Accountability Act of 2009, addresses these concerns raised by our industry and the agriculture sector and restores confidence of the commercial trade and lending institutions. It will facilitate market fundamentals, not speculative activity, resulting in accurate price discovery.

The cotton industry acknowledges the importance of market liquidity and the essential function speculative interests perform in our commodity markets. In our view, by requiring full transparency and accountability of speculative trades, the proposed legislation would not discourage speculative participation in the commodity contracts. Market liquidity is essential, but it must be tempered and monitored, and it should not dictate the direction of the market.

In the current regulatory structure, Congress's CFTC has imposed speculative position limits in our futures contracts to reduce the potential for market disruption or manipulation. Such limits are no longer effective for three reasons: first, hedge exemptions granted to investment funds allowed them to exceed the limit; second, large traders using swaps exemptions operate outside the regulatory framework altogether; and third, nontraditional trader's speculative limits are only imposed as these contracts go into convergence.

The other significant area of concern is the exempt status afforded swaps transactions that are executed off-exchange with each party mutually agreeing to satisfy each other's credit standards, and to remit margins to one another as the underlying market fluctuates. Such transactions pose problems when one of the parties has a hedge exemption that exempts his or her on-exchange futures trading from position size limits.

These arrangements, along with billions of dollars invested in index funds, has brought so much cash into our markets that the traditional speculators could not take a short position to match the institutional longs. This left it up to the commercials to offset these positions. But, lacking the necessary capital to meet the huge margin requirements, they could not do so. The result is a market with no economic purpose for the commercial traders. Simply put, the investment funds have negated the real purpose of our futures markets.

In order to restore the integrity of the markets, and to ensure they fulfill the basic roles of price discovery risk management and hedging, the cotton industry has developed a number of recommendations that are incorporated into the legislation before the Committee.

First, establish trading limits to prevent excessive speculation; second, subject all contract and over-the-counter market participants to speculative position limits; third, subject speculative entities to the same weekly reporting requirements as the trade; and finally, limit hedge exemptions and limit eligibility for hedge margin levels to those actually involved in the physical handling of our commodities.

The cotton industry also believes that the lack of transparency and disparate reporting requirements by market participants is appropriately addressed by legislation requiring the CFTC to disaggregate index funds, and publish the number of positions and total value of the index funds and other passive, long-only, short-only investors and data on speculative positions relative to their *bona fide* physical hedges. And also to establish reporting requirements for index traders and swap traders in designated market contracts, derivative transaction execution facilities and all other trading areas.

In addition to these necessary changes, the cotton industry feels strongly that the CFTC should require the IntercontinentalExchange and its clearinghouse members to adhere to the practice of margining futures to futures settlements and options to options settlements.

Also, the cotton industry has an important *caveat* for both the Committee and the CFTC. We submit that no action should be taken to discourage over-the-counter transactions with legitimate commercial purposes, transactions that are transparent and have proven to be beneficial risk management tools. It is essential that we encourage commercial innovation for those producing, merchandising or using physical commodities traded in the futures market.

In closing, I would like to stress restoring confidence in the futures markets is of the utmost importance, and we thank you for considering our views.

[The prepared statement of Mr. Taylor follows:]

PREPARED STATEMENT OF GARY W. TAYLOR, CEO, CARGILL COTTON COMPANY, CORDOVA, TN; ON BEHALF OF NATIONAL COTTON COUNCIL; AMERICAN COTTON SHIPPERS ASSOCIATION; AND AMCOT

Chairman Peterson, Ranking Member Lucas, and Members of the Committee, I am Gary Taylor, CEO of Cargill Cotton Company in Cordova, Tennessee. Cargill Cotton is a division of Cargill, Incorporated, an international provider of food, agricultural and risk management products and services. We service growers, ginners, buyers and textile mills worldwide through our network of buying, selling and shipping offices and our cotton gins and warehouses. I appear today representing the members of the National Cotton Council, the American Cotton Shippers Association, and AMCOT, a trade association of marketing cooperatives.

We appreciate your scheduling this week's hearing and the outstanding leadership you have provided this past year on this subject critical to farmers, marketers, processors and consumers of agricultural and energy products. The involvement of the Committee this past year exemplifies its interest and its willingness to effectively oversee the commodity futures markets and to address issues vitally important to the functioning of the U.S. economy.

Impact of Futures Markets on Cotton Industry

The sound and effective regulation of a transparent futures market would provide significant benefits to the cotton industry, which is concentrated in 17 cotton-producing states, stretching from Virginia to California with the downstream manufacturers of cotton apparel and home furnishings located in virtually every state. The industry and its suppliers, together with the cotton product manufacturers, account for more than 230,000 jobs in the U.S. The annual economic activity generated by cotton and its products in the U.S. is estimated to be in excess of $100 billion.

In the past year, the cotton industry has undergone severe financial strain due to the uncertainty and unpredictable risk caused by a dysfunctional futures market. Coming to light is the damage of the March 2008 debacle in the ICE No. 2 Upland Cotton Contract as a number of first handlers have been forced into bankruptcy, several have announced orderly closures, and most have seen their assets dwindle to a critical level. Traditional merchandising relationships between growers and buyers have ceased because price risks are too great for short hedging purposes. Growers continue to be concerned about the financial viability of marketing entities with whom they have previously contracted crop sales. The inability of merchandisers to hedge their risks translates into a weaker basis and lower prices offered to the cotton producer. Each penny reduction in the price of cotton means that U.S. cotton farmers lose $85 million in revenue. Therefore, to insure the survival of our marketing structure, the cotton futures market must be returned to its historical function of price discovery and risk management relative to real market conditions.

The Lesson Learned

As the cotton industry and the agricultural complex informed this Committee in 2008, investment funds and over-the-counter (OTC) operatives flooded the futures markets with record amounts of cash, throwing the trading fundamentals out of balance, resulting in a widened basis, and thereby making these markets illiquid for those for whom Congress created these markets. The presence of large speculative funds and index funds in the energy and agricultural futures contracts distorted the futures and the physical or cash markets of these commodities. The abundance of unregulated cash allowed these funds to overwhelm these markets negating their primary purposes.

Long before others in the Congress or the regulatory agencies recognized the problem or began to take action, the House Agriculture Committee had hearings underway and appropriate legislation before the Congress. Now, the leaders of the developed and developing world are calling for the U.S. to effectively regulate the commodity markets. We commend the Committee for that bipartisan foresight and believe that the legislation before the Committee, *The Derivatives Markets Transparency and Accountability Act of 2009,* would address the concerns raised by the cotton industry and the agricultural sector and restore the confidence of the commercial trade and the lending institutions. Above all, it will facilitate market fundamentals, not speculative activity, resulting in accurate price discovery in the futures markets.

The Importance of Market Liquidity

The cotton industry acknowledges the importance of market liquidity and the essential function the speculative interests perform in the commodity markets. We welcome that participation and do not wish to discourage it. In our view, the legislation before the Committee by requiring full transparency and accountability of speculative trades would not discourage speculative participation in the commodity contracts. Market liquidity is essential, but it must be tempered and monitored—it should not dictate the direction of the market.

Speculative Position Limits and the Swaps Exemption

In the current regulatory structure of the futures markets, Congress, through the CFTC, has imposed speculative positions limits in the futures contracts to reduce the potential for market disruption or manipulation. But such limits are no longer effective for three reasons:

1. The CFTC has granted Hedge Exemptions to the investment funds allowing them to exceed the limits;

2. Large traders were permitted by Congress, through the Swaps Exemption, to operate outside the regulatory framework altogether; and

3. Non-traditional traders speculative limits are only imposed as contracts go into convergence.

The other significant area of concern is the exempt status afforded Swaps transactions that are executed off-exchange with each party mutually agreeing to satisfy each other's credit standards and to remit margins to one another as the underlying market fluctuates. Such transactions, however, pose problems when one of the parties to the Swap has a "Hedge Exemption" that exempts his or her on-exchange futures trading from position-size limits.[1]

These arrangements, along with the billions of dollars invested in index funds, brought so much cash into the market that the traditional speculators could not take a short position to match the institutional longs. This left it up to the commercials to offset these positions. But lacking the necessary capital to meet the huge margin requirements, they could not do so.

That has been the situation this past year as the funds continued to purchase futures. Unwilling to assume such margin risks in such a volatile futures market, the commercial traders were forced to remain passive not only in the futures, but in the

[1] In such situations, the Swaps dealer would take an equal and opposite position in the futures market to the Swaps trade. For example, should a pension fund desire to purchase $20 million in long exposure in a commodity, it can purchase this exposure from a Swaps dealer. The dealer, now short the price of that commodity via the Swap, enters the futures market to hedge his position by buying futures in that commodity. Given that he is a "hedger," the CFTC allows him to trade futures in excess of the normal speculative position-size limits. This has created a situation where such large investors can trade in any contract in any size they desire without regard to position limits. They are not limited by the CFTC. Only a Swaps dealer can limit such trades, and it is unlikely that a Swaps dealer would turn a deaf ear to a financial entity awash in cash.

physical markets as well. The result: markets with no economic purpose for the commercials. Therefore, no business was done. Producers, lacking a price, could not properly plan and processors had to buy hand to mouth. Simply put, the investment funds have negated the real purpose of the futures markets, causing severe disruptions in the marketing process.

Cotton Industry Recommendations

In order to restore the integrity of the futures and derivatives markets and to ensure that such markets function properly by providing price discovery and hedging thereby allowing producers and manufacturers to lock in prices and merchants and cooperatives to offer forward prices to producers and manufacturers, the U.S. cotton industry has developed a number of recommendations that are incorporated in *The Derivatives Markets Transparency and Accountability Act of 2009*. Congress should:

- Establish trading limits to prevent excessive speculation,
- Subject all contract and over-the-counter market participants to speculative position limits,
- Subject speculative entities to the same weekly reporting requirements as the trade, and
- Limit hedge exemptions and limit eligibility for hedge margin levels to those actually involved in the physical handling of the agricultural commodity.

The cotton industry also believes that the lack of transparency and disparate reporting requirements by market participants is appropriately addressed by the legislation by requiring the CFTC to:

- Disaggregate index funds and publish the number of positions and total value of the index funds and other passive, long-only and short-only investors, and data on speculative positions relative to their *bona fide* physical hedges, and
- Establish reporting requirements for index traders and swap dealers in designated contract markets (exchanges), derivative transaction execution facilities and all other trading areas.

In addition to these necessary changes, the cotton industry feels strongly that the CFTC should require the IntercontinentalExchange and its clearing house members to adhere to the practice of margining futures to futures settlements and options to options settlements.

Also, the cotton industry has an important caveat for both the Committee and the CFTC. We submit that no action should be taken to discourage over-the-counter transactions with legitimate commercial purposes—transactions that are transparent and have proven to be beneficial risk management tools utilized by producers, merchants, and manufacturers. It is essential that we encourage commercial innovation for those producing, merchandising, manufacturing, or using the physical commodity traded in the futures markets.

In closing, I would like to stress that restoring confidence in the futures market is of the utmost importance to our industry. Thank you for considering our views and recommendations during the development and consideration of this vitally important legislation.

The CHAIRMAN. Thank you, Mr. Taylor, for your presentation.

Mr. Pickel, welcome to the Committee.

STATEMENT OF ROBERT G. PICKEL, EXECUTIVE DIRECTOR AND CEO, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, NEW YORK, NY

Mr. PICKEL. Thank you, Chairman Peterson, Ranking Member Lucas, and Members of the Committee. Thank you again for asking us to testify before this Committee, this time regarding the Derivatives Markets Transparency and Accountability Act of 2009.

It is worth noting at the outset that OTC derivatives have continued to perform their important risk management function during the current market turmoil. It is our hope that policymakers will keep in mind the relative health of OTC derivatives throughout the market downturn as you consider measures which might profoundly change the way these markets function.

As I noted before this Committee in December, the roots of the current global financial crisis lie in imprudent decisions, particularly with respect to residential housing. OTC derivatives were not the cause of the current financial crisis. OTC derivatives have remained available, despite the recent market turmoil. This has enabled companies to hedge risk that would have had a significant adverse financial impact on them, but for a well-functioning OTC derivatives market.

Parties to OTC derivatives have received the benefit of their bargain, and the legal certainty provided by the Commodity Futures Modernization Act is a big reason for this. OTC derivatives serve a very valuable purpose. They allow companies to manage risks like interest rate risk, foreign exchange risk, commodity price risk and credit risk. The financial system and the economy as a whole are stronger and more resilient because of OTC derivatives. OTC derivatives are a way for businesses to obtain protection against market events that they cannot control.

Despite many claims to the contrary, it is also worth remembering that the overwhelming majority of OTC market participants use collateral to protect themselves against loss.

The Agriculture Committee has a great deal of experience with the OTC derivatives market. Going back to the earliest days of OTC derivatives, this Committee helped create the framework for legal certainty which underpins the health and success of the U.S. OTC derivatives business. This legacy of leadership has helped create a thriving, vibrant risk management industry, which even today, amidst the global financial meltdown, continues to employ thousands of Americans and provide tax revenue to states and the Federal Government.

However, portions of this bill would severely harm these markets and prevent them from functioning properly in the United States, while also impairing the ability of American companies to hedge their risk. More importantly, the consequences of certain of the provision of this bill would harm many mainstream American corporations. Many American corporations use OTC derivatives to hedge their cost of borrowing or the operating risks of their business.

Many of those who do business overseas need to hedge their foreign currency exposure. Some American corporations may also hedge their commodity or credit exposure. The current wording of the bill would have a disastrous effect to the large majority of these corporations by taking away risk management tools that American corporations use in the day-to-day management of their business.

Regarding some specific provisions of the legislation, let me make the following comments:

Section 6 would effectively eliminate the hedge exemptions for entities which use the futures market to gain exposure to certain asset classes, or which facilitate risk management by other entities which cannot or choose not to use the futures markets. The effect of this provision would be to severely limit the use of the hedge exemption and thus access to the futures markets. This would likely result in more costly hedging, increased volatility, reduced liquidity and a deterioration in the price discovery function of futures markets.

Section 11 of the bill authorizes the CFTC to impose position limits on OTC transactions if the agency determines that transactions have a potential to disrupt a contract traded on a futures markets or the underlying cash market. There is a lack of credible evidence or academic studies to support the proposition that derivatives markets cause imbalance in cash markets.

In addition, this provision allows the CFTC to order otherwise regulated institutions such as banks and broker dealers to terminate their privately negotiated contracts. This provision effectively gives the CFTC the authority to cancel OTC derivative contracts.

We have also concerns about the mandatory clearing provisions of section 13. Clearing can provide benefits and in appropriate cases should be encouraged. However, it is not clear what justification there is for a requirement that all OTC contracts should be cleared. To the contrary, since the advent of the OTC derivatives market, bilateral credit arrangements have been used to settle contracts smoothly and efficiently. There is simply no evidence suggesting anything other than the bilateral credit arrangements contained in standard ISDA documentation work extremely well.

Finally, section 16 makes it unlawful to enter into a credit default swap unless the person entering into the transaction would experience a financial loss upon the occurrence of a credit event. This provision would effectively eliminate the credit default swap business in the United States.

This provision would mean that a dealer could not hedge its risks. Therefore, the only participants in the CDS market would be counterparties which each had perfectly matched risk which they had sought to hedge. The number of such persons is likely to be extremely small.

In conclusion, OTC derivatives markets play an important role in the U.S. and world economy. Despite exaggerated reports to the contrary, they did not cause the market meltdown and, in fact, have helped mitigate the effect of the downturn for many institutions. OTC derivatives remain an essential element in returning our financial system to full health, and harming these markets is not in keeping with that goal.

This Committee is to be commended for addressing these questions and seeking answers to help set right our economy. But to the extent oversight of OTC derivatives markets need review and reform, it should be part of a larger dialogue on reform of the financial system in general.

I look forward to your questions, and I thank you for inviting us today.

[The prepared statement of Mr. Pickel follows:]

Prepared Statement of Robert G. Pickel, Executive Director and CEO, International Swaps and Derivatives Association, New York, NY

Mr. Chairman and Members of the Committee:

Thank you very much for allowing ISDA to testify at this hearing regarding the "Derivatives Markets Transparency and Accountability Act of 2009". We are grateful to the Committee for seeking a broad range of views as it considers legislation addressing the bilaterally negotiated or OTC derivatives industry. It is worth noting at the outset that these markets have continued to perform their important risk management function during the current market turmoil. It is our hope that policymakers will keep in mind the relative health of OTC derivatives throughout the market downturn as you consider measures which might profoundly change the way these markets function.

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 800 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; 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. ISDA continues to provide clarity and certainty to the risk management industry through our collaborative initiatives with market users and policymakers worldwide.

OTC Derivatives and the Current Market Turmoil

As I noted before this Committee in December, the roots of the current global financial crisis lie in imprudent lending decisions, particularly with respect to residential housing but also extending to other areas including consumer receivables, auto finance and commercial development. These imprudent decisions were reinforced by credit ratings of securities composed of these loans which proved to be grossly overconfident, and by faulty risk management practices of some of the institutions investing in those securities. These securities should not be confused with derivatives.

One thing that should by now be clear is that OTC derivatives were not the cause of the current financial crisis. In fact, had the Commodity Futures Modernization Act of 2000 (CFMA) not been passed we would find ourselves in exactly the same financial crisis we are in today. Indeed the crisis might be worse, as the CFMA created legal certainty for OTC derivatives and thus allows market participants to hedge risk through privately negotiated risk management contracts. It is worth noting that the OTC derivatives market has continued to function despite the recent market turmoil. This has enabled companies to hedge risks that, without a well functioning OTC derivatives market, would have had a significant adverse financial impact on them. The derivatives markets have remained open and liquid and fulfilled their hedging purposes while other asset prices have collapsed.

OTC derivatives serve a very valuable purpose: they allow companies to manage risks, like interest rate risk, foreign exchange risk, commodity price risk and credit risk. The financial system and the economy as a whole are stronger and more resilient because of OTC derivatives, and those that disparage their use, or confuse them with asset backed securities and collateralized debt obligations (or CDOs, an acronym that leads to some confusion with the straightforward credit derivative instrument CDS) which have proved illiquid and difficult to value in the current crisis, threaten to damage a sector of the financial services industry that remains healthy.

Some point to the large outstanding notional value of OTC derivatives as somehow representing a source of concern. It is important to understand first that notional values represent an underlying quantity upon which payment obligations are calculated. For example two parties may agree to an interest rate swap with a notional value of $10 million. Under that contact one party will pay to the other a fixed rate of interest on that $10 million, while the other will pay a floating rate of interest on that same amount. At no point do the parties exchange $10 million, and at no point is $10 million dollars at risk. Nevertheless, when referring to notional amounts of OTC derivatives, that is precisely what people are doing: notional amount refer to hypothetical amounts of money, not money that is actually at risk.

However there is an even more fundamental point to be made about notional amounts: to the extent they represent actual money at risk, they are representing *risk that is being hedged.* Notional figures indicate how much protection parties have purchased against some underlying, uncontrollable risk. In general policymakers have concluded that encouraging risk management is sound public policy, and so it would seem to still be the case today. OTC derivatives are a way for businesses to obtain protection against market events that they cannot control.

It is also worth remembering that the overwhelming majority of OTC market participants are collateralized to protect themselves against loss. Standard industry practice requires counterparties to secure one another against the possibility that the other party will fail to make its required payments. The ability to access this collateral in the event of default is protected under Federal law, and this has proved to be an important way to minimize the fallout of insolvency in the current market.

The Draft Bill

The Agriculture Committee has a great deal of experience with the OTC derivatives market. Going back to the earliest days of OTC derivatives this Committee helped create the framework for legal certainty which underpins the health and success of the U.S. OTC derivatives business. The Futures Trading Practices Act of 1992 gave the CFTC exemptive power and directed the agency to use this authority to exempt swap agreements. When the Commission acted in ways which called into question the viability of that exemption this Committee adopted an amendment in the 1999 Agricultural and related agencies appropriations act which reinforced the enforceability of OTC derivatives and prevented the CFTC from challenging their exemption under the law. In 2000, of course, this Committee led the way in adopting the Commodity Futures Modernization Act which most clearly established the legal framework for the U.S. OTC markets. And as recently as last year this Committee reaffirmed that framework when it passed the CFTC Reauthorization Act of 2008.

This legacy of leadership has helped create a thriving, vibrant risk management industry which even today, amidst the wreckage of the global financial meltdown, continues to employ thousands of Americans and provide tax revenue to the states and Federal Government. However portions of this bill would severely harm these markets and prevent them from functioning properly in the United States while also impairing the ability of American companies to hedge their risks.

More importantly the consequences of certain of the provisions of this bill would harm many mainstream American corporations. Many American corporations use OTC Derivatives to hedge their cost of borrowing or the operating risks of their business. Many of those who do business overseas need to hedge their foreign currency exchange rate exposure. Some American corporations may also hedge their commodity or credit exposure. The current wording of the bill would have a disastrous effect for the large majority of these corporations by taking away basic risk management tools that American corporations use in the day to day management of their of business.

Below are a few selected provisions of the legislation which bear particular mention:

Section 6: Trading Limits

This section requires the CFTC to establish position limits for all commodity futures contracts traded on an exchange or exempt commercial market which offers significant price discovery contracts. These position limits would be required to be established for all commodities, including financial commodities. As an initial matter we question whether it is necessary to establish position limits for financial commodities given that the markets are broad, liquid and have an effectively limitless supply.

The section would effectively eliminate the hedge exemption for entities which use the futures market to gain exposure to certain asset classes, or which facilitate risk management by other entities which cannot or choose not to use the futures markets. The effect of this provision would be to severely limit the use of the hedge exemption and thus access to the futures markets. This would likely result in more costly hedging, increased volatility, reduced liquidity and a deterioration in the price discovery function of futures markets. It is also of note that this provision is based on the unproved, and if several credible studies are to be believed disproved, theory that speculation creates higher prices.

Section 11: Over-the-Counter Authority

This provision authorizes the CFTC to impose position limits on OTC transactions if the agency determines that the transactions have the potential to disrupt a contract traded on a futures market, or the underlying cash market. As stated above, there is a lack of credible evidence or academic studies to support the proposition that derivatives markets cause imbalances in cash markets. Supply and demand inexorably determine prices. In addition, this provision allows the CFTC to order otherwise regulated institutions such as banks and broker/dealers to terminate their privately negotiated contracts. This seems to represent an unwarranted intrusion into the jurisdiction of other Federal regulators. Lastly, as OTC derivatives contracts are privately negotiated agreements between two counterparties this provision effectively gives the CFTC the authority to cancel private contracts. This fundamentally undermines legal certainty, would make it difficult for parties to calculate how much capital to hold against such contracts and would likely cause a significant decrease in OTC activity.

Section 13: Clearing

This section requires that all currently exempted and excluded OTC transactions must be cleared through a CFTC regulated clearing entity, or an otherwise regulated clearinghouse which meets the requirements of a CFTC regulated derivatives clearing organization. The provision gives the CFTC the authority to provide exemptions from this requirement provided that the transaction is highly customized, infrequently traded, does not serve a significant price discovery function and is entered into by financially sound counterparties.

Clearing can provide benefits and in appropriate cases should be encouraged. However it is not clear what justification there is for a requirement that all OTC derivatives should be cleared. To the contrary, since the advent of the OTC market bilateral credit arrangements have been used to settle contracts smoothly and efficiently. These arrangements have been supported by Federal law and policy, which promotes netting and close-out of bilateral agreements in the event of the bankruptcy of a counterparty. These arrangements have been tested both in the market and in the courts and have been successfully used to settle thousands of OTC trades. During the current market turmoil we have witnessed the failure or default of a major OTC dealer (Lehman Bros.), two of the largest issuers of debt in the world (Fannie and Freddie), and a sovereign country (Ecuador). Indeed, on an almost weekly basis there are failures which call into action the carefully crafted settlement provisions of ISDA documentation. In every case the contracts have settled according to their terms and according to market expectations, with net settlements changing hands being much smaller than media pundits had anticipated (in Lehman's case, approximately $5bn changed hands in respect of CDS contracts). There is simply no evidence suggesting anything other than that the bilateral credit arrangements contained in standard ISDA documentation work extremely well. While clearing should be encouraged, and market participants continue to work with Federal and international regulators to create a viable clearing solution for OTC derivatives, mandating clearing of all OTC derivatives is unwarranted.

Section 16: Credit Default Swaps

This provision makes it unlawful to enter into a CDS unless the person entering into the transaction would experience a financial loss upon the occurrence of a credit event. This provision would effectively eliminate the CDS business in the United States.

As written the provision would make it impossible for sellers of protection to hedge their own risks. Most dealer firms, which by and large are federally regulated banks, run a hedged portfolio which seeks to minimize their losses in the case of a loss on a particular contract. Thus for CDS, a dealer firm will seek to ensure that if it has to pay out protection under a CDS contract it will within its own portfolio have a hedged position to minimize its loss. This provision would mean that a dealer could not hedge its risks. Therefore the only participants in the CDS market would be counterparties which each had perfectly matched risks which they sought to hedge. The number of such persons is likely to be extremely small.

This provision would also have the effect of turning all CDS into insurance contracts as it requires parties to a CDS to show a loss. As such under most state insurance statutes a party to a CDS would be required to be regulated by state insurance law, thus bringing federally regulated institutions under the authority of local state authorities.

As noted above this provision would effectively end the CDS business in the U.S. As noted in this testimony and elsewhere the credit derivatives market has continued to function throughout the downturn, providing a way for market participants to hedge credit risk and express a view on market conditions. Limiting access to credit derivatives would create disincentives to lending at a time when Federal authorities are seeking to promote lending in order to restart the economy. It is difficult to see what public purpose would be served by destroying these currently healthy and important markets.

Conclusion

OTC derivatives markets play an important role in the U.S. and world economy. Despite hyperbolic reports to the contrary they did not cause the market meltdown, and in fact have helped mitigate the effect of the downturn for many institutions.

To the extent some participants in the markets have suffered losses related to derivatives, or failed to adequately secure themselves or their counterparties against the possibility of losses, this reinforces the need for sound risk management practices and a careful review of the actions of regulators charged with overseeing these institutions. OTC derivatives remain an essential element in returning our financial system to full health, and harming these markets is not in keeping with that goal.

This Committee is to be commended for addressing these questions and seeking answers to help right our economy. But to the extent oversight of OTC derivatives markets needs review and reform it should be part of a larger dialogue on reform of the financial system in general. Acting hastily is likely to have unintended consequences and prove counterproductive.

The CHAIRMAN. Thank you, Mr. Pickel.

And, last, Mr. Morelle, welcome.

STATEMENT OF THE HON. JOSEPH D. MORELLE, ASSEMBLYMAN AND CHAIRMAN, STANDING COMMITTEE ON INSURANCE, NEW YORK ASSEMBLY; CHAIRMAN, FINANCIAL SERVICES AND INVESTMENT PRODUCTS COMMITTEE, NATIONAL CONFERENCE OF INSURANCE LEGISLATORS, TROY, NY

Mr. MORELLE. Good morning, Chairman Peterson, Ranking Member Lucas, my good friend who hails from Monroe County, Congressman Massa, and Members of the Committee. Thank you for allowing me to testify on a matter key to the stability and well-being of our Nation's financial system.

I am New York State Assemblyman Joseph Morelle, testifying on behalf of the National Conference of Insurance Legislators, or NCOIL. I chair the New York State Assembly Committee on Insurance, and serve as Chairman of NCOIL's Financial Services Committee.

NCOIL is a multi-state organization comprised of legislators whose main area of public policy concerns insurance.

I am pleased to be here today on behalf of NCOIL to discuss the provision of the draft legislation that relates to credit default swaps, and the question of whether and how to regulate this vast and yet somewhat obscure marketplace.

On a point of interest, this is the third hearing in which I have participated regarding CDSs. I chaired the first two, one in my capacity as Chairman of the Assembly's Insurance Committee and the other as Chairman of NCOIL's Financial Services Committee.

I congratulate the Committee for its commitment to gain and provide a greater understanding of the importance of credit default swaps. Frankly, this discussion is not only appropriate but overdue. It is a discussion with broad implications that go to the fundamental notions of how to effectively regulate and strengthen the free market system.

In recognition of this, NCOIL has, like the Committee, turned its attention to the critical questions surrounding CDSs: namely, what manner of financial instrument are they; and, once defined, how shall they be subject to the safeguards that are a fact of life for the buyers and sellers of other similar financial instruments?

On behalf of NCOIL, I would like to spend the time that I have been allotted to address these questions and make the following points:

CDSs are, in fact, a species of insurance, and naked swaps are more akin to gaming than insurance since they lack insurable interest. The states are best suited to regulate this type of financial guaranty.

Relative to the question of whether CDSs are a species of insurance, I point to New York insurance law, section 1101. Insurance contract means any agreement or other transaction whereby one party is obligated to confer benefit or pecuniary value upon another party dependent upon the happening of a fortuitous event in which the insured or beneficiary has or is expected to have at the time of such happening a material interest which will be adversely affected by the happening of such event.

Or, as defined in a letter dated February 23rd, 2006, by the GAO, insurance is a contract whereby one undertakes to indemnify another or pay a specified amount upon determinable contingencies.

What is a credit default swap? Simply put, it is a financial guaranty against a negative credit event. A negative credit event triggering a CDS payment clearly meets the definition of a fortuitous event, one occurring by chance.

In recognition of these facts, the NCOIL Financial Services Committee approved a 2009 committee charge to explore the role of CDSs. And, as I mentioned, NCOIL held a public hearing on January 24th regarding proper marketplace regulation and the role of states in that regulation. NCOIL was represented by legislators from Connecticut, Kentucky, Mexico, North Dakota, and New York.

While NCOIL took no formal action at the hearing, members generally agreed on a few broad principles: Credit default swaps are a form of insurance; naked swaps lack insurable interest and more closely resemble directional bets than insurance; state legislators and regulators should be responsible for regulating this market; and the CFMA played an unexpected and negative role in the proper and necessary regulation of swaps.

The Financial Services Committee will chart a formal policy course for the organization later this month.

The third point, in reference to state primacy in insurance regulation, is rooted in decades of established law. From the McCarran-Ferguson Act of 1945 established state preeminence in the area of insurance legislation and regulation. If we conclude that CDSs are a species of insurance, than regulatory authority must accrue to the states.

It is our position that state regulators, with their extensive experience at regulating insurance products, are uniquely qualified to regulate covered CDSs as insurance. They are best able to ensure that the standards set for the insurance industry, such as insurable interest, reserving requirements, and insolvency tests are met by CDS providers.

Respectfully, it is our position that Congress erred by preempting the states from regulating CDSs when it passed the CFMA.

I would note parenthetically that state regulation of insurance is not to blame for the difficulties at AIG. State subsidiaries of AIG remain solvent and robust. The problem with CDS is deregulation by CFMA. That Act permitted so-called naked swaps, contracts that are speculative in nature and are merely directional bets on market outcomes, to proliferate to the point where it is estimated they now constitute 80 percent of the market.

Let me state clearly that, as a matter of philosophy, that we believe that the Committee is on the right track in banning naked swaps. We believe naked CDSs pose a threat to global financial stability.

Section 16 of the draft bill makes it a violation of the Commodity Exchange Act to enter into a naked CDS. The language establishes that a party could not enter into such contract unless it had direct exposure to financial loss should the referenced credit event occurred. Furthermore, it defines the term of a contract which ensures a party to the contract against the risk that an entity may experience a loss of value as a result of an event specified in the contract, such as a default or downgrade.

We agree that they are insurance, and with the direction and spirit of the legislation now before you, even as we again, respectfully, aver that the implementation of a CDS regulator mechanism should be at the state level.

Speaking for myself, however, I would respectfully suggest a broadening of the definition of covered swaps to include those that provide a legitimate hedge against negative credit events. In the domain of naked swaps, there is a critical need to delineate between those that are purely speculative and those in which some direct or indirect exposure ties the buyer to the insured asset. For example, an owner or investor of Ford dealerships may want to hedge their exposure to a negative credit event by purchasing a CDS on Ford.

The point of demarcation is not so much one of clothed *versus* naked, but rather hedge *versus* speculative.

Although CDSs used for hedging activity may not contain as direct an exposure as owning an underlying bond, they may contain an indirect exposure or insurable interest. Such activity can be identified through GAAP accounting, which requires derivative transactions be disclosed as either hedging or speculative.

Thus, any prohibition on speculative CDS contracts, in my view, must make this distinction between the clear differences that exist in the inherent interest and nature of contracts that are purely speculative, and those in which there is a demonstrable exposure, direct or indirect, related to the contract buyer.

In closing, NCOIL urges that the Committee and Congress consider the question of whether the goals of this draft bill would be best realized and enacted by the states; whether the CFMA was overbroad in its intent and application; and whether the powers removed from state government in relation to the Act might be restored as an avenue to establish what President Obama in his inaugural address called the watchful eye of oversight necessary to ensure that freedom in the financial markets does not degenerate into simple and destructive anarchy.

It has been my pleasure, privilege and distinct honor to appear before you today on behalf of NCOIL. I look forward to working with you and the Committee as it moves forward in its review of CDS regulation. Thank you.

[The prepared statement of Mr. Morelle follows:]

PREPARED STATEMENT OF HON. JOSEPH D. MORELLE, ASSEMBLYMAN AND CHAIRMAN, STANDING COMMITTEE ON INSURANCE, NEW YORK ASSEMBLY; CHAIRMAN, FINANCIAL SERVICES AND INVESTMENT PRODUCTS COMMITTEE, NATIONAL CONFERENCE OF INSURANCE LEGISLATORS, TROY, NY

Introduction

Good afternoon Chairman Peterson, Ranking Member Lucas, and Members of the Committee. Thank you for inviting me to testify before the Committee on a matter key to the stability and well-being not only of our nation's financial system, but, as we have learned, the U.S. economy as a whole.

I am New York State Assemblyman Joseph D. Morelle, testifying this morning on behalf of the National Conference of Insurance Legislators (NCOIL). I chair the New York State Assembly's Standing Committee on Insurance and serve as Chairman of NCOIL's Financial Services & Investment Products Committee.

NCOIL is a multi-state organization comprising legislators whose main area of public policy concern is insurance. NCOIL legislators chair or serve on committees responsible for insurance legislation in their respective state houses.

I am pleased to be here today on behalf of NCOIL to discuss draft legislation titled the "Derivatives Markets Transparency and Accountability Act of 2009," and the greater question of whether and how to regulate this vast and yet somewhat obscure marketplace. On a point of interest, this is the third hearing in which I have participated regarding credit default swaps; I chaired the first two, one in my capacity as Chairman of the Assembly's Insurance Committee and the other as Chairman of NCOIL's Financial Services and Investment Products Committee.

Credit Default Swaps as Insurance

I greatly appreciate the opportunity to offer testimony in this instance, and heartily congratulate the Committee for its commitment to gain and provide a greater understanding of the importance of credit default swaps. Frankly, this discussion is not only appropriate but, perhaps, sadly overdue.

It is a discussion with implications beyond even the very broad horizons of its specific subject matter, for it relates to our fundamental notions of the free market system, a system that has produced wealth more prodigiously than any other but which, absent oversight, can result in the rapid destruction of institutional and personal assets and reverse the hard-won achievements of a generation of Americans.

In recognition of this, and particularly in the wake of the near collapse of American International Group, Inc. last September, NCOIL has turned its attention more closely than ever to the critical questions surrounding credit default swaps: namely, what manner of financial instrument are they and, once defined, how shall they be subject to the safeguards that are a fact of life for the buyers and sellers of other similar financial instruments?

Why NCOIL? Primarily because of a rising conviction on the part of many observers that credit default swaps constitute a species of insurance, and should be regulated as such. Certainly, I have come to strongly believe that they do indeed meet the standing definition of insurance, and therefore, are best left to the regulatory purview of the states, whether acting collectively or individually.

On behalf of NCOIL, I would like to spend the few minutes that I have been allotted to make the following points: (1) credit default swaps are a species of insurance; (2) naked swaps are more akin to gaming than insurance since they lack "insurable interest"; and (3) that the states are best suited to regulate this type of financial guaranty.

Under New York State Insurance Law, § 1101: "Insurance contract" means any agreement or other transaction whereby one party, the "insurer," is obligated to confer benefit of pecuniary value upon another party, the "insured" or "beneficiary," dependent upon the happening of a fortuitous event in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event.

What is a credit default swap? Simply put, a credit default swap is a financial guaranty against a negative credit event. A negative credit event triggering a credit default swap payment certainly meets the definition of a "fortuitous" event, one occurring by chance, under New York statute.

The NCOIL Process

In recognition of these facts, the NCOIL Financial Services and Investment Products Committee last November approved a 2009 Committee charge to "explore the role of credit default swaps and other financial instruments, develop a position, and communicate to legislative colleagues regarding their public policy implications."

And as I alluded to earlier in these remarks, the NCOIL Steering—Officers, Chairs, and Past Presidents—and Financial Services Committees convened a public hearing in New York City on January 24th to receive testimony from interested parties regarding proper marketplace regulation and the role of state lawmakers and NCOIL in that regulation. NCOIL was represented by legislators from Connecticut, Kentucky, New Mexico, North Dakota, and New York.

New York State Insurance Superintendent Eric Dinallo, and representatives of the International Swaps and Derivatives Association (ISDA), Assured Guaranty and the Association of Financial Guaranty Insurers (AFGI), AARP, the National Association of Mutual Insurance Companies (NAMIC), and the American Academy of Actuaries, among others, testified at the hearing. For your reference, electronic testimony is available on the NCOIL web site at *www.ncoil.org*.

While NCOIL took no formal action at the hearing—the Financial Services Committee will chart a policy course for the organization during the NCOIL Spring Meeting, which will be held here later this month—members generally agreed on a few broad principles, including that:

- credit default swaps have many of the characteristics of insurance transactions.
- so-called "covered" swaps closely resemble financial guaranty insurance.
- "naked" swaps are very troubling because they lack insurable interest and more closely resemble directional bets than insurance.
- state legislators and regulators should be responsible for regulating the credit default swap market.
- by preventing states from enforcing long-standing regulatory statutes, the *Commodity Futures Modernization Act* played an unexpected and negative role in the proper and necessary regulation of swaps.

States as Insurance Regulators

This final point, in reference to state primacy in insurance regulation, is rooted in decades of established law. As the distinguished Members of the Committee know, the McCarran-Ferguson Act of 1945 established the state preeminence in the area of insurance regulation. If we conclude that credit default swaps are a species of insurance, and I would strongly argue that they are, then authority in relation to CDS must accrue to state legislatures and state insurance regulators.

It is NCOIL's position that state regulators, with their extensive experience at regulating insurance products, are extremely qualified to regulate covered CDS as insurance products. They are best able to ensure that the standards set for the insurance industry at large—such as identification of insurable interests, institutional solvency and the other elements essential to indemnification—are met by CDS providers as well.

Thus, respectfully, it is also NCOIL's position that Congress erred when it preempted the states from regulating CDS under our gaming and bucket shop laws when it passed the Commodities Futures Modernization Act of 2000 (CFMA). The CFMA permitted so-called "naked swaps"—those CDS contracts that are speculative in nature and are merely directional bets on market outcomes—to proliferate to the point where they now constitute 80 percent of the CDS market, which has a notional value of around $54 trillion, with no regulatory framework.

Let me state clearly that as a matter of philosophy, the members of NCOIL believe that this Committee is on the right track in banning "naked" swaps. We believe that naked CDS pose a dangerous threat to global financial stability.

Defining Naked Swaps

Section 16 of the draft bill makes it a violation of the Commodity Exchange Act to enter into a "naked" credit default swap. The language establishes that a party could not enter into such a contract unless it has a direct exposure to financial loss should the referenced credit event occur. Furthermore, it defines the term "credit default swap" as a contract which ***insures*** a party to the contract against the risk that an entity may experience a loss of value as a result of an event specified in the contract, such as a default or credit downgrade.

Again, NCOIL agrees that credit default swaps are insurance, and with the direction and spirit of the legislation now before you, even as we again, respectfully, aver that the actual implementation of CDS regulatory mechanism should be at the state rather than Federal level.

Speaking for myself, however, I would respectfully suggest a broadening of the definition of clothed or covered swaps to include those that provide a legitimate hedge against negative credit events. In the domain of naked swaps, there is a critical need to delineate between those that are purely speculative and those in which some "stream of commerce" ties the buyer to the insured asset. In other words, if a CDS were used for hedging rather than speculative purposes, we should consider that the economic utility of such transactions as more than mere speculative activity. For example, an owner or investor of Ford dealerships may want to hedge their exposure to a negative credit event by purchasing a credit default swap on Ford.

The point of demarcation, then, is not so much one of "clothed" *versus* "naked" swaps, but rather "speculative" *versus* "hedged."

Although CDS used for hedging activity may not contain as direct an exposure as owning an underlying bond covered by a CDS, an insurable interest exists which can be identified through GAAP accounting—which requires that CDS be listed as used for hedging or speculative purposes.

Thus, any prohibition of speculative CDS contracts, in my view, must make this distinction between the clear differences that exist in the inherent intent and nature of contracts that are purely speculative and those in which there is an arguable "stream of commerce" related to the contract buyer and, therefore, whether legitimate and beneficial economic stimulus is derived by permitting such contracts to occur.

Conclusion

In closing, NCOIL urges that the Committee and Congress consider the question of whether the goals of the transparency and accountability draft would be best realized and enacted by the states; whether the CFMA of 2000 was overbroad in its intent and application; and whether the powers removed from state government in relation to that Act might be restored as an avenue to establish what President Obama in his inaugural address called the "watchful eye" of oversight, necessary to ensure that freedom in the financial markets does not degenerate into simple and destructive anarchy.

It has been my pleasure, privilege and distinct honor to appear before you today on behalf of NCOIL and all those whose interests are impacted by this Committee's deliberations. We look forward to working with the Committee as it proceeds in its review of credit default swap regulation.

I certainly stand ready at this time to answer any questions you may have. Thank you.

The CHAIRMAN. Thank you, Mr. Morelle. We appreciate your being with us.

I visited with Mr. Dinallo last week. He was here at the Committee, and because of the direction we were moving he decided to stand down, I guess, for the time being on the question of what they are going to do.

New York has a good knowledge of this and being a lot of it is based there, I think your folks are pretty knowledgeable. What about the other states? I am not sure some of these other states even know what this stuff is.

So I guess you haven't gotten that far, but how would you guys regulate this? If the states did this, you would put capital requirements on the people that are involved in this? Or would you do it on individual transactions or contracts? How exactly would it work?

Mr. MORELLE. Well, thank you for the question, Mr. Chairman.

First of all, I am appearing on behalf of National Conference of Insurance Legislators. I think we agree that a group of states together in either compact or with model legislation would come up with a national standard that could be used. And, obviously, as you point out, New York has a special position relative to this kind of regulation. In many ways, this mirrors the work that we do with bond insurers, where we require reserving, as we would do with any underwriter of risk, as well as insuring those insurable interests.

The speculative activity simply put, in our view, is gaming, and that is what I believe the Superintendent has said at various times. We are working together, but we would work with the various states, and we would have reserving requirements, as we do for what we call monoline insurers, those insurers who write bond insurance.

The CHAIRMAN. I guess you guys haven't gotten to the bottom line on this, and you are going to have a meeting and come with more specific recommendations. I get the sense then that where you guys are coming from is you think these naked swaps, CDSs, are gambling and basically you would ban them?

Mr. MORELLE. Yes. With the only *caveat* to that as I mentioned in the testimony. We require, under New York State law, life insurers to file with us a derivative use plan. And under state law they are allowed only to use derivatives or credit default swaps as a hedge, as opposed to speculative activity. And from my perspective, speaking for myself, to narrowly construe naked swaps as only those that have a direct exposure or insurable interest is probably too narrow, and instead to look at a broader definition which would include indirect exposures as well.

I mentioned the example of a Ford dealership and Ford credit default swap as a way to hedge legitimate exposure. I think we would take the view, however, that anything in which there was not some connection in commerce to exposure would be gaming.

The CHAIRMAN. So like the airlines using whatever it is, heating oil, as something that is close to jet fuel because jet fuel really doesn't have a market, or that kind of thing, is what you are talking about?

Mr. MORELLE. That would be correct.

The CHAIRMAN. What do you say to the folks that are saying the world is going to come to an end and that these CDSs have been a big help in all of this, and what we are doing here is going to make matters worse because these things have been wonderful and provided liquidity? What do you say to that?

Mr. MORELLE. Again, respectfully, sir, I would argue a couple of things.

First of all, they are referred to often as bilateral contracts, but I would argue that they are trilateral contracts in that you and I and the 300 million Americans have stepped up to the plate to provide the backstop on many of these contracts. So I don't necessarily agree with that.

I would also argue that risk needs to be dealt with in a reasonable way. I also think sacrificing legitimate risk management at the altar of liquidity has led us down a dangerous path. I certainly don't dispute the fact that credit default swaps play an important role in our financial institutions, but they are insurance, they are a financial guaranty and ought to be treated as such. And those who have no insurable interest, frankly, I would continue to argue, are purely speculative, and add nothing of value to the real economy.

The CHAIRMAN. But you guys wouldn't actually set up a system where every contract was kind of looked at individually and the margins set on them and so forth. You would have a more broad type of regulation and requirements, right?

Mr. MORELLE. Well, presumably, we would have the underwriters of those bonds. The sellers of protection would be treated in a manner similar to the way that we treat monoline insurers, those who write bond insurance and are required to reserve on the contracts that they write.

The CHAIRMAN. How would we be assured that there wouldn't be risk here that was more than there was capital to cover? I am very skeptical about what the SEC is doing in the way that they regulate. They try to do things at the front end, and it is hard to get whatever authority you need out of them. They run you through a whole bunch of bureaucracy, but then they don't have anybody to check things, as you have seen with Madoff and so forth.

So if we move in that direction, how could we be sure that the states would ferret out this risk and we wouldn't be entering into a bunch of risky contracts that are going to end up at the doorstep of the taxpayers again?

Mr. MORELLE. I would point out that, as it relates to state regulation of insurance companies, that we have reserving requirements and insolvency tests. The question about collateral calls, which is often talked about, a posting of collateral; typically, the collateral posted is not nearly the amount of collateral necessary to be able to pay claims. So reserving does do it. It requires an analysis of losses, projected losses based on histories, and we have not had those insurers who have defaulted in regulated states. We have not had defaults. In fact, they remain robust and strong.

I point out AIG, for instance, the subsidiary companies are robust; and we do that through reserving and making certain that when people take on risk or underwrite risk they have adequate resources to be able to cover the claims.

The CHAIRMAN. I have taken more time than I should, but if the Committee will bear with me. I know you guys are good at doing that, but one of the things that everybody brings up is this. These things are hard to price and figure out what the risk is and so forth. You guys believe you have the expertise to be able to do that?

Mr. MORELLE. I believe we do, and the superintendents of the various states together with NAIC, which is their organization, in conjunction with NCOIL would certainly be able to put standards in place that would meet that requirement.

The CHAIRMAN. My guess would be that what you will require will probably shut down this market more than what we are talking about. Because you are going to be requiring some significant reserves to cover this risk, I would guess.

If the Committee will indulge me, is there a way to have an arrangement where you would be involved in setting the regulation for systemic risk, or whatever you want to call it, and that we would have some kind of a system within the CFTC that would have some kind of margining requirement on the instruments so there would be some combination of the two? Is that a possibility?

Mr. MORELLE. I think it is, Mr. Chairman, and we would certainly love to work with you and the Committee and Congress on that. We do think there is an appropriate and important role to play for the states. And I would again suggest that one of the hallmarks of insurance regulation is that when people make commitments on future events that there is the ability to meet those commitments. That clearly has not happened in many cases that we have talked about, AIG being the most prominent. But, as well, in many of the other investment banks and some of the banks that are under distress right now.

I certainly think there is a role to play and a combination of the responsibilities and the strengths of the various levels of government to provide that security. But, I am not persuaded in the conversations that I have had and the testimony we have taken that prudent risk management should be sacrificed in the effort to have more and more liquidity. That is part of the problem that we have gotten ourselves into.

The CHAIRMAN. I agree with you.

I thank the Committee for the indulgence, for giving me a little extra time.

The gentleman from Oklahoma, Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman.

Mr. Pickel, would you care to comment on Mr. Taylor's testimony that this bill will not discourage speculators from participating in commodity markets?

Mr. PICKEL. We focus on the trading limits and the hedge exemption provisions. Keep in mind that we represent the bilateral, privately negotiated derivatives business. In that role, parties, whether we are talking about interest rates or other types of commodities, would typically be entering into bilateral contracts that are tailored to the particular needs of the counterparties.

The dealer in that situation hedges its risk in various ways. If it can find an offsetting position with another bilateral trade it will do that, but often it looks to manage that risk via the futures markets. That is the root of the hedging exemption that is provided for, is to recognize that ability for the dealer to hedge its position that it takes on the bilateral trade it may wish to access the futures market and, therefore, that is the appropriate role for that exemption.

Mr. LUCAS. Mr. Taylor, along those lines, in Mr. Pickel's testimony he notes that supply and demand ultimately determine prices and that speculation does not increase prices. Would you care to offer some observations on that point?

Mr. TAYLOR. Well, probably the best testimony I can offer on that is that there is an ongoing CFTC investigation of what happened in our market on March 3rd and 4th of 2008. And for those who don't know, we had a 1 day event on March 3rd where the market traded from the mid-70¢ to well over a dollar synthetically with no fundamental reason for that happening. So we will know soon, hopefully, when the CFTC does respond or issue their report, what did cause that. But, that to me, at least on the face of the evidence of what happened that 1 day, would suggest that perhaps there were some other forces and factors that were entering our market that caused the distortion to occur.

Mr. LUCAS. Would anyone else on the panel care to touch on any of these points?

Mr. Short and then Mr. Masters after that.

Mr. SHORT. Thank you.

I would just like to comment. The market that Mr. Taylor was referring to is ICE Futures U.S.'s cotton market. Based upon the exchange's examination of facts, we have not found that that price spike was due to speculative interest.

I don't want to comment on the CFTC's ultimate finding. He is correct. There is an ongoing review that is being undertaken. But, based upon the exchange's view, it was a convergence of a number of issues, including commercials having to cover their short positions that led to the price spike. Certainly ICE as an exchange is very concerned about Mr. Taylor's views, because without his commercial interest you really don't have a market. So we are working with the commercial sector to make sure that there is proper convergence and proper margining of positions on the exchange.

Mr. LUCAS. Mr. Masters.

Mr. MASTERS. I would just like to put out the idea that more and more people now, especially the American public in general, have come to the conclusion that there was no doubt that there was a significant amount of speculation in crude oil markets, and indeed, most of the commodity markets over the last 9 months.

You will notice in my testimony we put out a report on that in which we calculate that the excessive speculative activity over the last 6 months cost the average American $850 per capita, per household, in excess of $110 billion over that period of time. And it is interesting to me that dealers from Wall Street and other folks can come up and say, well, money moves markets in everything but commodities. Of course money moves markets in commodities. We had money coming in. We had $70 billion come in, and we had $70 billion come out.

Let me just read you a couple of statements that have come out subsequent to our initial testimony about excessive commodity speculation. One of them is from Paul Tudor Jones, who is probably considered one of the greatest commodity traders of all times. He said, "There is a huge mania, and it is going to end badly. We have seen it play out over hundreds of times over the centuries, and this is no different. It is just the nature of a rip-roaring bull market."

I will give you another example, Dr. Bob Aliber from the University of Chicago. He is a distinguished professor. He said, "You have got speculation and a lot of commodities, and that seems to be driving up the price. Movements are dominated by momentum players who predict price changes from Wednesday to Friday on the basis of the price change from Monday to Wednesday."

Since our testimony, organizations such as the World Bank, the United Nations, MIT, the Austrian Ministry of Finance, the Japan Ministry of Trade and other organizations and academics around the world have come out and said there is no doubt that excessive speculation was a primary cause for the movements we saw in commodities markets over the last year.

So, to your question, I would say that the speculation absolutely had a role, and could continue to have a role in prices in the commodity futures markets.

Mr. LUCAS. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The gentleman from Pennsylvania, Mr. Holden.

Mr. HOLDEN. Thank you, Mr. Chairman.

For those of you who oppose the draft provision on naked credit default swaps, could you accept mandatory clearing of naked credit default swaps as an alternative to the outright ban? And for those of you who support the draft provisions, would a clearing mandate alleviate your concerns about the instruments?

Mr. PICKEL. Yes. I would say that, from our perspective, and we commented in our testimony regarding the mandatory clearing requirement, again, we look at and put in place the infrastructure that is used for OTC derivative trades, including credit default swap trades over the past 20 plus years, and that infrastructure works extremely well.

There is a master agreement which parties enter into. It provides the benefits of netting, which the Congress has recognized repeatedly as a beneficial risk management tool. It also is very common and certainly recommended that people consider the usage of collateral to collateralize those positions.

So when we look at suggestions of mandatory clearing, we look and point to the infrastructure that exists and does work. We don't see a need to, even in the credit default swaps space, to require clearing.

Now a number of firms have voluntarily committed to regulators via the New York Fed, and there have also been discussions with the European Commission about committing to put as much of their credit default swap trades as possible through one of the several clearinghouses that are under consideration. I think that is a positive step.

There is the ability to utilize clearing as another means, an additional tool in the infrastructure that we put in place to help manage risk most effectively. Forcing everything to go from here over to there ties people's hands in terms of their ability to manage risk effectively.

Mr. HOLDEN. Anyone else on the panel want to comment?

Mr. SHORT. I would add to Mr. Pickel's comment that clearing goes a long way to address many of the issues with CDS; whether that clearing would be done under ICE's clearinghouse, or any of the other competing clearing models such as CME, or some of the other industry participants. I think the counterparty credit risk and remediation, and the transparency the clearing would bring would benefit the market significantly.

I will note that we don't believe that all CDS can necessarily be cleared. There are certain CDS that, due to the lack of standardization in the product and lack of liquidity, it really wouldn't make sense to clear. This Committee actually hit upon a very good framework to address that type of issue when it passed the farm bill.

In the case of exempt commercial markets, when different contracts served a significant price discovery function, a similar template could be applied here where one CDS had attained a certain level of liquidity, or there was some systemic risk issue. You might require clearing of CDS at this point and not make it mandatory for all CDS. But, certainly, those CDS that are liquid, and capable of being cleared, we are in favor of having them cleared.

Mr. HOLDEN. Anyone else on the panel care to comment?

Mr. MORELLE. I would just like to note that the argument that naked CDSs, as I would define them, that don't provide any hedge at all but are purely speculative, aren't a tool for risk management since there is no risk on the part of the buyer of the protection.

While the clearing makes a great deal of sense potentially for the hedged or clothed or covered swaps, I would want to know more about the construct of them and how they work, the proposed ones. I would still argue that the naked swaps, to the extent that I defined them, should not be permitted because there is no risk management involved because there is no risk.

Mr. HOLDEN. I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Mr. Taylor, I know that I heard from a number of my producers when we had the anomalies in the cotton market, and everybody was scrambling as they wanted to certainly find a way to sell at the prices the commodity contracts moved to. Since then, things have seemed to have stabilized some. Can you kind of give me a quick snapshot? Currently, are the markets behaving in a more normal way and are producers able to cover or put in place the risk management that they need to do?

Mr. TAYLOR. Yes, things have normalized to some degree, but there has been so much stress and a number of competitors of ours have vanished, as I mentioned in my testimony. There is not the richness or the number of offers that are out there for cotton. There are offers. It is traded. It is just not as robust.

And I would say that producers are probably not receiving a traditional basis for the cotton that they are selling. We probably took out 30 to 35 percent of our merchandizing capacity in that 1 week. And that competition is good for everyone, and we have less of it.

Mr. NEUGEBAUER. Now you advocate for aggregate position limits for noncommercial traders. One of the things this body is struggling with is making sure that we don't push so many people out that we can't actually handle the appropriate amount of liquidity in the marketplace, so that our producers can use this as an effective price discovery and risk management tool.

When I think about a bale of cotton in the 19th Congressional District, I think about all of the people who really have some commercial interest in that. All the way from the seed company to the fertilizer and the equipment company, the gins and merchants, and other people relying on the behavior of the cotton commodity price for their livelihood.

So kind of two things begin to come to my mind there. When we start picking, who can and cannot participate in hedging a risk that they perceive, or putting together a business model where they can manage those risks? And, also, if we push too many people out of the marketplace, then if you have this many people trying to use a commodity as somewhat of a business hedge, that we don't have enough people to be on the other side.

What is the right prescription of who you allow to play and who you don't allow to play?

Mr. TAYLOR. Well, this is America, and I think everybody ought to be able to play. But everybody needs to play by the same rules, and positions need to be reported, people need to have the same opportunity.

We do not want to not allow people to play. We just want people to report, people to have a consistent behavior and consistent requirements in limits and all operate with the same rules. I think that what we are proposing here is transparency, full disclosure, aggregating positions, so that we all know when an event is taking place and we are prepared for it, and the market can digest it. We are all fine with that. So we certainly don't want to discourage participation. We need speculators in all of our markets and don't want to do anything to eliminate that.

Mr. NEUGEBAUER. Are there places where cotton is traded over-the-counter or where there isn't. For example, transparency, anybody using anything off of an exchange for cotton. I am asking this question, because I don't know the answer.

Mr. TAYLOR. We have a number of products for cotton producers and cotton textile mills tailored to their specific price risk needs. So there are a number of those things. I don't think it is particularly significant, but it is very helpful for them to manage their costs. You know, options markets, there are only five cotton options per year, and an element of the cost of those options is the time value. So we have products that tailor that time-value cost to that specific need.

I don't think that disclosing positions, aggregating positions, in our market would have any negative impact on prohibiting people from participating.

Mr. NEUGEBAUER. So I want to be clear and understand you. So you would be, for these products that you offer in a specialized way, you would be for clearing those in a way where there would be open transparency of what the prices and the terms of those are?

Mr. TAYLOR. To an earlier point here, some of those are so specialized and unique that it would be difficult to clear those because the terms are unique to that transaction, probably aren't significant. There probably isn't a ready market to clear those. So we would in those cases like to deal directly with our producers or with our textile mill customers, and not clear those. That would add significant costs and wouldn't really add any value at all to that transaction.

Mr. NEUGEBAUER. But would you disclose it?

Mr. TAYLOR. We are for disclosure, but not necessarily clearing.

Mr. NEUGEBAUER. Because it just isn't a uniform transaction?

Mr. TAYLOR. That is correct.

Mr. NEUGEBAUER. Thank you very much.

The CHAIRMAN. I thank the gentleman.

The gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

I do have a couple of concerns about the legislation. I serve on the Foreign Affairs Committee and I am a member of the NATO Parliamentary Assembly, and as such I get the opportunity to travel abroad three to four times a year to meet regularly with our colleagues from other countries, especially Europe, the Middle East and Asia. And as such, I have become especially conscious of how our actions are viewed outside of these walls, outside of the country.

Recently at the World Economic Forum in Dubai, a cloud hung over the discussions about solving the current economic crisis permeating almost every country in the world, and the fears that nations would resort to economic protectionism, as is typical in tough economic times as these, that seemed to dominate these discussions.

It is understandable that countries would seek to preserve jobs for citizens and assure their own quality of life. We see this manifest in Buy-American provisions, increased domestic subsidies, our increased tariffs. However, this protectionism comes at a price. They more often than not invite some form of retaliation from our partners around the world. We need look only to the jurisdiction of this Agriculture Committee for examples. Indeed, we have been battling protectionist policies for years in the agriculture sector to try to open up markets for U.S. goods, and have had some difficulty in doing so.

I say this because I fear that we may be inviting some of this same retaliation with certain provisions of this bill, particularly with elements of the foreign boards of trade language.

So I wanted to try to open up a discussion on that by first of all asking you, Mr. Short, yesterday the CME Group expressed concerns with section 3 of the draft which deals with foreign boards of trade. They fear that these provisions will offend our foreign partners and in fact provoke retaliation.

Now, in your testimony, assuming the draft was corrected in the manner which you support in your testimony, do you think such fears are justified? Second, if so, why haven't we heard directly from our foreign partners about this?

Mr. SHORT. I don't really have a view on the issue of whether you have heard from foreign partners on this. I think the draft legislation is relatively new and that may be yet to come.

I do think there is a fundamental problem with the relative size of market provision in section 3 because it applies a different standard to a foreign exchange accessing these markets than it would to a domestic exchange, and ultimately that is going in the wrong direction.

As far as codifying the other elements of section 3 and the no-action regime that ICE Futures Europe presently operates under, at a high level you would probably find a receptive audience internationally to having information sharing and transparency in contracts that are linked to domestic markets.

I am not terribly troubled by section 3, absent the relative size of markets provision, because as I mentioned in my testimony, I ultimately think that governments in the United States and in all major developed nations are going to have to work on standards that address those issues because we really live in global world and a global marketplace.

Mr. SCOTT. You have discussed your concern about the form of discrimination and the size the markets. But let me just mention this to you. Others might counter that position limits set for a larger market like NYMEX, for example, might not necessarily be appropriate for a smaller market even on the same contract.

How do you respond to is that?

Mr. SHORT. I would respond to that that is not the correct view to take, because ultimately where someone will trade is dependent upon market liquidity, being able to provide tight markets. If you imposed a very small position limit because a new competitor was launching a contract and didn't have significant market share, you would just never develop the liquidity to make it worth the trading party's while to trade in your market. So, the key here is transparency and not have a doubling up, if you will, of position limits or accountability, but not kind of putting a hard limit on positions based upon the relative size of markets.

Mr. SCOTT. Mr. Chairman, could I have 30 seconds to ask a follow-up question?

I wanted to ask a follow-up question to Mr. Taylor who brought up a point about ICE and clearing. Your testimony asked that the CFTC should make ICE and its clearing members adhere to the practice of margining futures to future settlements and options to options settlement. What has ICE done differently and how has it impacted cotton trading, for example? And if it is a different practice, do other exchanges behave similarly or not?

Mr. TAYLOR. There have been some changes since last March, but what occurred at that time was when we had that rapid rise, that 1 day increase in the market, we were required to margin our positions to what we call synthetic or option closes, and that created a tremendous amount of financial pressure. In fact, it caused, I believe, some commercial interests to have to close their positions because they didn't have the financial wherewithal to make the margin call.

What we have proposed is that we have daily trading limits, we stop trading when we hit those limits, and we margin to those. We have currently 3¢, 4¢, and 5¢ limits depending on the number of days the market has moved, and that is the way we, as the cotton committee, wish to operate. That is very similar to the way the grains operate.

Now, in ICE's defense, our committee actually was on board with the margining that took place on that day, so we have to look in the mirror when we place the blame there. But we are working with ICE to modify the rules, to stop the trading and to margin to those daily trading limits, and not a 20¢ to 30¢ move, which is what we had on that day.

Mr. SHORT. If I could add one point, the whole issue arises because there is a limit in the amount that a price can move in the cotton contract, and the situation that was faced by the exchange was we hit the limit and the OTC market and options markets were indicating that the real price was going well above that limit. From the standpoint of properly margining positions in the clearinghouse, we have to protect all market participants. We used the synthetic price indicated by the options price rather than where the futures price cut off. From our perspective we were trying to do what was right from the standpoint of risk management.

Mr. SCOTT. Thank you. Thank you for your courtesy, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Scott.

The gentleman from Louisiana, Mr. Cassidy.

Mr. CASSIDY. No questions.

The CHAIRMAN. No questions. I think we have to get a Republican. Who is next here? Unless you want to switch parties, Mr. Massa.

Mr. MASSA. No, no.

The CHAIRMAN. The gentleman from Pennsylvania, Mr. Thompson.

Mr. THOMPSON. No questions.

The CHAIRMAN. The gentleman from Texas, Mr. Conaway.

Mr. CONAWAY. Well, Mr. Chairman, the risk of replowing old ground that has already been plowed by a newcomer just walking in here is greater than the chance I might come up with something that hasn't already been asked, so I yield back.

The CHAIRMAN. All right. I am going to recognize now, out of order, the gentleman from Iowa, who is the Chairman of the Subcommittee that has jurisdiction, and then we will get back to the regular order.

Mr. BOSWELL. Thank you, Mr. Chairman, and thank all of you for your presentations today and comments. I am quite sure you are aware of what happened yesterday, so any comments you might make about that would be appreciated.

For starters to Mr. Masters and Mr. Taylor, a number of witnesses today, and yesterday, testified in spite of the draft bill's purposes of promoting transparency and accountability, its provisions will have the unintended effects of disrupting market liquidity and sending trading activity either offshore or on to otherwise unregulated trading venues.

Please respond to that and share your concerns or your comments. I will start with you, Mr. Masters.

Mr. MASTERS. Thank you. I think that is an empty threat. I think that the idea that folks are going to go offshore for all of their trading has been an idea that has been promoted by the futures industry and other folks as a scare tactic to prevent regulation, necessary regulation, in our markets. In fact, if they really want to trade over there, I am not sure we shouldn't buy them a one-way ticket, because the bottom line is that without significant government intervention, AIG, and $110 billion, it is very likely that our markets would have had a systemic meltdown. Fiduciaries today are not going to go to a place where they are worried about counterparty.

There are some people worried about counterparties in the U.S., there are some people worried about the U.S. as a counterparty, but I can tell you there are a lot of people worried about counterparties in other places, including Dubai and whatnot.

That is just not where folks want to go. They do not want to trade with less transparency and with less regulation. Trustees of large institutional investors want to trade with more regulation and more transparency, and the U.S. should take the lead on that. And I am quite sure that the FSA and other regulatory jurisdictions will follow along. Whatever path we choose, it is very likely they are going to follow us. So, that is just something not even in the realm of possibility right now.

Mr. BOSWELL. Thank you very much.

Mr. Taylor?

Mr. TAYLOR. Yes. Thank you for the question, and I guess I probably need to answer that within the context of cotton, which I know better than the other commodities. But we do have an exchange in China that is being used principally by the Chinese. There are a few companies that do use it. But I would echo the comments made at the end of the table that this probably is an empty threat.

Participants want to go where they can trust the market, where there is reporting, there is no "funny business" or a minimum of "funny business" going on. We enjoy today a preferred position. Our market is trusted. The regulated people, participants are very comfortable using the ICE exchange. So, we need to be mindful of that risk.

I do think as China develops, and China is the largest producer of cotton, the largest consumer of cotton, the largest exporter of textiles, there is that opportunity. But with their attitude with foreigners in general, and foreign investment, currencies, *et cetera*, it will be difficult for them to continue.

Mr. BOSWELL. Mr. Pickel?

Mr. PICKEL. Yes. Regarding the threat of business moving overseas, when you outlaw a particular type of contract, parties will have no choice but to go elsewhere to trade that. Certainly under the laws of the U.K., for instance, where the bulk, the majority of credit default swap trading occurs, it is very clear that the full range of transactions is available to parties in London to trade those. There are other venues, Hong Kong and London, where they would continue to actively trade those transactions. I think when you make things illegal, it is very clear business would move elsewhere.

Regulation imposes costs. Costs would be looked at on the margin. On the margin, yes, some people are going to look to do certain transactions elsewhere. Whether the entire business dies or not would remain to be seen. But when you make things unlawful, as section 16 does, that business will move elsewhere.

I think also as it relates to AIG, which is certainly the situation where credit default swaps are involved, there was a question of the risks they were taking on, the fact they didn't use collateral, and the fact that they did not make a proper assessment of risk. Those are all very serious concerns, but they didn't relate to the product itself.

Mr. BOSWELL. I appreciate that.

Mr. Taylor, I have been concerned for our cotton growers for a long time. We will talk about that someday. I have never planted or held a cotton seed in my life, but I still feel very concerned about it, and we will talk.

Mr. Masters, I want to address this back to the Chairman. You and I kind of participate in PAYGO and things of that nature and we think it is important, which it is. But, with the stimulus and the new Administration and all these problems—first off, we are a world community, and you are pointing that out.

I think that we are into an area, Mr. Chairman, where we have to have transparency and honesty and oversight like we have never had before, and that this panel and those folks that you brought yesterday and today, you got to help us. We have to make this work, because if any of you fail, we all fail. We can't do that to this country.

A lot of you, like me and many others up here, are putting it on the line for this country. And, damn it, we can't let this happen, not for any particular reason, but just because of what we do. So it is time that we have to bite the bullet, and that is what our President challenged us to do when he talked to us in his inaugural address.

It is you, and you, and you, and you, and me, and if we are not willing to do that, shame on us. You can tell your children that I had my chance and I screwed it up. I think we have one chance. Maybe I am making too strong a statement here, but we have one chance, and we better not muck it up.

So if you have some real strong feelings about how you can contribute, and I think you do, I have a lot of confidence in you, we have to come to the forefront and do this right.

This Chairman is trying to put a bill forth that will help us, and if it needs some tweaking, let's talk about it. That is what we are doing. But we can't continue business as we have been doing it. You know it, I know it, and the whole world knows it.

So that is where this guy is coming from. I am educable. I am a good listener. I think we have our feet to the fire. We are standing on the precipice, we could fall off the edge. And I don't want it to happen on my watch, any more than you do, and I know you don't.

So, please, this is asked: Let's do it together, and if we have to suffer a little, let's suffer. Let's do it now, instead of passing it on to those coming behind us. There has been too much of that going on. It has got to stop, and we are the ones that have to do it. Ain't nobody else gonna do it. It is up to us.

I would like for all of you, this country has to lead. That is what we are all about. So let's do it.

Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. I thank the gentleman.

The Committee went to Europe the first week in December, and I came away with the impression that this threat of going to foreign markets does not hold water either. One of the things that came up again and again over there is the bankruptcy laws. And they say until they change the bankruptcy laws in Europe, that we have a big advantage built in; plus the fact that, as Mr. Masters said, people want to be here. The Chinese are buying Treasury bills for zero percent interest because they think it is safer to do that than to buy securities someplace that has a return that they are not sure about.

The gentleman from Georgia, Mr. Marshall.

I am sorry, I apologize to the former Chairman and Ranking Member. My good friend Mr. Goodlatte from Virginia is recognized.

Mr. GOODLATTE. Mr. Chairman, thank you. If I can pass for a round, I would appreciate that.

The CHAIRMAN. The gentleman from Georgia, Mr. Marshall, is recognized for 5 minutes.

Mr. MARSHALL. Thank you, Mr. Chairman.

Gentleman, I am going to have to ask that some of you answer for purposes of the record; in other words, do a little bit more work after this hearing responding to questions, because I just have too many questions for you to respond to verbally now. I apologize for the extra work. I would like for you to respond not only for the record, but if you could send your responses to my office as well, I appreciate it.

Mr. Morelle, God bless you and I appreciate your interests, but I just can't imagine the regulatory arbitrage problems that we would have if we broadened this to 50 jurisdictions within the United States. We already have regulatory arbitrage problems, and it is just hard for me to fathom. Particularly when our principal concern is how this affects our money supply globally, and how this affects the large institutions that are too big to fail, at least we are identifying them as too big to fail. We are here largely because of that right now. And to suggest that individual states will be having a large say in decisions that could affect global money supplies, national money supplies, just seems far-fetched to me. You might want to comment on that if you could in writing.

You also define "naked" too broadly. It seems to me that if one institution needs hedging and they go to A and A says sure, I will hedge with you, then A has this risk. A then might go to B and say—A, by the way, in deciding whether or not it can actually cover the risk, is taking into account the fact that it could conceivably to go to B, C and D. But it goes to others and tries to lay off that risk.

So A, I would assume in a reasonable definition of what is "naked," that person wouldn't be naked. And then going to the next person or the next entity, yes, that entity to start out with has no interest, but once that entity has gone ahead and covered some of the risk or offset the risk somehow, then B has got an interest. Then you see where I am going. So it is the characters that are totally on the sideline that just want to place bets among themselves that you really have in mind as being naked.

Mr. Masters, you are arguing for position limits on and off-exchange and I have a lot of sympathy for that, but I suspect that maybe a lot of what you want to accomplish can be accomplished by simply having CDSs cleared. I should say that those that aren't cleared would be only permitted if some regulatory body, I would think the CFTC, says grace over them, probably in advance. There would have to be some sort of general scheme, the kinds that will be permitted, the kinds that won't.

Then the clearinghouses are making public not the details of the private transactions, but generally making public information to enhance public transparency. And if the CFTC were required to do the exact same thing with regard to these things that aren't being cleared but are transparent to regulators, it seems to me, it is going to be an absolute minimum. I think that might accomplish a lot of your objectives.

What worries me that everybody is going to have these position limits, on-exchange off-exchanges, that means that market makers, traditional market makers that are important to the liquidity of the market, they could be caught up in this and somehow limited in offering their liquidity. And they haven't been part of the problem. You don't think they are part of the problem, I don't think they are part of the problem.

Then there are traditional speculators, who are not, as was described by Mr. Gooch yesterday as "invesculators," who are not invesculators. They aren't just using these markets as a means to invest in commodities or something like that, they have helped us with price discovery and liquidity as well, historically. So if you could give some thought as to whether or not some lesser approach than simply across-the-board position limits would work, that would be great.

Mr. Pickel, I am saving the best for last. I have the impression that the industry, you are the industry spokesperson and I credit you with being very effective in your job, but you are just stonewalling here. It is fine to say that there is no credible scholarship out there that demonstrates that CDS is a substantial part of the problem. A lot of obvious logical arguments for why they would be exist. But, at this point it would be very helpful if the industry produced credible scholarship showing that they aren't part of the problem as opposed to simply saying there isn't anything proving it.

I think the burden has shifted at this point, and that is certainly the attitude in Congress and the attitude publicly. So I would encourage you to step forward with some real credible information that this is not a problem. And I would ask that the industry start considering compromises instead of just blowing through all of this, and saying that any compromise just doesn't make any sense that it would lessen liquidity substantially and cause people to run off overseas, *et cetera*.

One of the compromises that has been suggested is this clearing compromise. Obviously all things can't be cleared, so some process that would take that into account, maybe CFTC approval to non-cleared under these circumstances, or specifically looking at non-cleared. And certainly there has to be at a minimum record-keeping, reporting to the regulator, with some sort of public reporting. I mean, you all need to start thinking about this and proposing something that works for your industry and will meet some of the real concerns that we have and solutions we are working on. And simply to stonewall repeatedly, I don't think cuts it here.

So if you want a quick—my time is up. I guess you ought to have time to at least respond to that, and then if you could respond in writing in general, that would be great.

Mr. BOSWELL [presiding.] We will be going back to the next round shortly, so we will just come right back to it.

Mr. Goodlatte, are you ready?

Mr. GOODLATTE. Thank you, Mr. Chairman.

Mr. Masters, just to clarify your testimony, the CFTC, by allowing an excessive speculation bubble, amplified and deepened the housing and banking crisis. Is that your conclusion?

Mr. MASTERS. That is. I think that the excessive speculation tax, if you will, the giant move upwards in energy and food prices that American consumers had to endure the first 6 months of this year, certainly it aggravated an economy that was already weakening, and that there is no question that it had adverse effects. You see in my testimony there are some folks in there that have made statements to that effect, economists, folks from the American Bankers Association, folks from the big city, the National Urban League said the same thing.

Mr. GOODLATTE. Let me ask, from your testimony it appears that you are a strong advocate of mandatory clearing through an exchange. Do you agree with the testimony that we received yesterday that that will only strengthen the large market players and those that can afford these margin requirements?

Mr. MASTERS. No, I don't think so. I think that the reason we are for exchange clearing is really two reasons. Number one, it is equal. It actually is more democratic. It is not just going to strengthen the large players. Obviously, the level of margin that is required is the key issue there. But in terms of preventing systemic risk, had AIG, for example, been trading their CDS, cleared it on an exchange, then they would have had to reserve significant amounts of dollars on the exchange, which would have really avoided the U.S. Government having to bail them out.

In other words, the real reason for exchange clearing is to avoid a systemic meltdown in the future. And the other reason is because in regulation, it really allows regulators, to understand on a real-time basis exactly the positions of these different participants. Right now one of the big issues in the over-the-counter market is we really don't have any idea. Nobody knows. And getting them on an exchange and having them clear allows regulators transparency, and it prevents the kind of systemic meltdown that we had this fall.

Mr. GOODLATTE. Well, tell me about the risks if we do that. I understand that and we have heard a lot of testimony with that, but what is the risk? Are going to encourage business to move overseas if we impose the same position limits on regulated exchanges, foreign boards of trade and over-the-counter markets?

Mr. MASTERS. Well, just so you know, I already commented on that on a previous question, I think it is an empty threat. I think there is very little risk that business migrates overseas, and I testified to that.

But in terms of the position limits, the best way to do position limits, and the reason we are for aggregate position limits, is because they treat speculators equally. Everybody is equal under that scenario.

You don't want to have a position limit on an exchange and then have no position limits in the over-the-counter market, because that encourages everybody to go off the exchange and trade over-the-counter. You don't want to have that kind of perverse incentive. What we would like to do, especially today given the meltdown we have had in the financial system, is allow folks to trade, encourage them to trade on an exchange where there is not counterparty risk.

So the whole idea of aggregate position limits, the reason for doing that is to treat everybody equally, whether you trade oil futures over-the-counter, whether you trade it with a dealer, whether you trade it in Dubai, whether you trade it on ICE, whether you trade it anywhere else. This is only if you are a speculator.

Mr. GOODLATTE. Let me interrupt you, since my time is running down here, and ask you if you want to respond to Mr. Short's testimony regarding the study that he cited, the study that found no link between index funds and market volatility?

Mr. MASTERS. I think common sense says that is not the case. We have plenty of studies that we can show that say that index funds were in fact an issue, and excessive speculation was a driver in creating the commodity markets bubble. There are studies from MIT, from the World Bank, from the United Nations. I saw one a couple days ago from the Austrian Ministry of Finance. There is one from the Japanese Ministry of Trade. There have been a lot of studies that have come to the opposite conclusion. So I could submit those if you would like to see them.

Mr. GOODLATTE. Mr. Chairman, if I could have leave to allow Mr. Short to respond to that, I would like to hear him.

Mr. SHORT. I would like to respond to Mr. Masters' statement and note that futures markets are inherently speculative markets. They are about predicting the future. So even Mr. Taylor, who is typically called a commercial or a hedger, is speculating about what the future price of something will be.

But what I really worry about here is whether we are making a distinction between speculators who are following a fundamental market trend and perhaps accelerating our discovery of what the future may hold, or are those speculators distorting the market? I think if it is the former and not the latter, candidly it is a good thing. Because, these future markets are the only early warning systems we have when there are fundamental problems in the marketplace, and the only signals that can be sent to consumers, producers, everybody, to modify their behavior appropriately. And I am really concerned that if you regulate speculators out of the market, you might not like the price signal that is being sent about the future, but I have yet to find a more predictive way to predict the future than a market.

Mr. GOODLATTE. Thank you, Mr. Chairman.

Mr. BOSWELL. Ms. Herseth Sandlin, the newest, happiest mother in the universe.

Ms. HERSETH SANDLIN. Thank you, Mr. Chairman, that is true.

Thank you all for your testimony. Mr. Pickle, I would like to start with you, a couple of questions. Much of the justification presented for past arguments that over-the-counter derivatives aren't appropriately regulated as futures stem from the fact that the transactions are customized and the creditworthiness of the counterparties is a material term.

With much of the market apparently now interested in centralized clearing, it is obvious that there is substantial standardization, and that the creditworthiness of the involved parties or the counterparties isn't an issue. So given the fact that the conditions seem to have changed, can we continue to justify the case that OTC derivatives aren't appropriately regulated as futures?

Mr. PICKEL. Well, let's look at the full range of the market. We focused a lot on CDS, and we will talk about that in a second. But if we look at interest rates, currency transactions, many commodity transactions, those are still very much custom tailored to the particular needs of the counterparties, the interest rate dates of the loans, or the delivery dates of the commodities. So in that area, yes, that continues to be the case. Custom tailored, the creditworthiness of the parties is very important. Collateral is used to address that credit exposure.

In the credit default swap markets, it is fair to say that in our documentation and in market practices, yes, on the spectrum of standardization we have moved further down that spectrum to more standardized products. And, that is why at this point clearing for those products becomes very compelling. The major dealers have been working on developing a clearing initiative here, which is now housed within ICE. They have been working on that for at least 2 and maybe 3 or more years. It has taken on a greater urgency in the last few months with the credit crisis, but they have understood the need, the attractiveness of a clearing option for those contracts in part because they are more standardized.

Ms. HERSETH SANDLIN. But you still continue to have concerns and perhaps oppose clearing provisions in the draft bill?

Mr. PICKEL. In terms of mandating clearing and saying that you have no choice but to clear the transactions. There is a very good example in the interest rate swap world where there has been a clearinghouse for close to 10 years over in London, dealers who are using that clearinghouse, are members of that clearinghouse, and have told me they use that very dynamically. It is another tool in their tool kit to manage risk. The OTC is the documentation structure with collateral and netting for many of the transactions, but they will put a number of those trades into the clearinghouse, and that just allows them to be much more dynamic in their hedging.

Ms. HERSETH SANDLIN. Your own testimony acknowledges the authority that the CFTC would have in exempting certain contracts.

Mr. PICKEL. Well, we look at the existing structure under the CFMA in terms of the exempt commodities, the excluded commodities, and that structure is how we look at the treatment of different types of financial instruments.

Ms. HERSETH SANDLIN. Okay. But I would like to just understand a little bit better. Since the draft legislation includes the authority to grant exemptions, do you question the CFTC's ability in particular to grant these exemptions? Is that where your concern lies?

Mr. PICKEL. Well, I guess our focus is more on the presumption that everything has to be cleared unless the standards for exemptions apply to that particular transaction. So, it is the presumption that everybody has to be cleared unless otherwise proven.

Ms. HERSETH SANDLIN. But you acknowledge that there is the authority to provide the exemptions?

Mr. PICKEL. In the legislation, I acknowledge that that is the path that the legislation takes.

Ms. HERSETH SANDLIN. You just are concerned—I want to get to the heart of this. I understand your concern that it assumes everything has to be cleared. But is it a concern you have with the CFTC's ability, or are you dissatisfied with the statutory provisions that set out when the CFTC could grant exemptions?

Mr. PICKEL. It is more focused than that. I have no question about the CFTC's authority or ability to analyze particular trades. I think it is the narrowness of the standards that apply to the ability to exempt, not the question of the CFTC's ability.

Ms. HERSETH SANDLIN. My time is running out, so just one more question for Mr. Short. Your written statement is silent on the provisions of the draft relating to clearing. And perhaps this has been asked before. What is ICE's views on the clearing provisions in the bill?

Mr. SHORT. On the issue of mandatory clearing of all products? I think our issue there is what I alluded to earlier in response to a question, which is that there are certainly products, derivative products, that should be cleared that are standardized, but there are also derivative products that probably aren't amendable to clearing. I think the proper framework would be to encourage clearing of standardized products that could present some level of systemic risk or have an important price transparency function in the broader marketplace, but to leave the nonstandardized, custom-tailored OTC instruments, like Mr. Taylor referred to, to the OTC marketplace.

Ms. HERSETH SANDLIN. Mr. Chairman, a quick follow-up, if I might. So what about the types of customized derivatives? Would you support some sort of evaluation by an entity about whether they might present a systemic risk?

Mr. SHORT. I think transparency to regulators is key here. I think we have moved beyond the days where people can argue that transparency to appropriate regulatory bodies isn't good. I am not sure I would go as far as to suggest that something needs to be preapproved to be traded. For example, that could lead to a lot of gridlock and maybe hamper product innovation. But certainly transparency would be appropriate to give the regulator the view about whether something needed to be cleared, or whether additional steps needed to be taken.

Ms. HERSETH SANDLIN. And you would be comfortable with the CFTC making those decisions?

Mr. SHORT. I am comfortable with the CFTC making those decisions. I am also very comfortable with the Fed making those decisions. As you know, our clearing solution is a bank that is governed by the Fed. But I have no quarrel whatsoever with the CFTC as a regulator.

Ms. HERSETH SANDLIN. Thank you, Mr. Chairman.

Mr. BOSWELL. Mr. Conaway, I am going to let Mr. Marshall get back in. I let him have that little extra follow-up, and if you will indulge us, let's do that because I have turned around and made up for it with others.

Mr. Marshall, I apologize. Let's wrap yours up.

Mr. MARSHALL. Am I limited to the subject matter?

Mr. Pickel, I guess the time has passed, and it really isn't necessary for you to respond to my observation. It is just troubling to me, that the industry, and that would mean you, aren't willing to give us a little bit more help here as opposed to just saying no, no, no. Make some suggestions. You sort of know where we are headed and what we are trying to accomplish. Or make some suggestions that will head us in that direction and still work for the industry.

Mr. Masters, on your call for equality in treatment, we all love that. We are all in favor of equality. I thought the concern from most, and I thought it was your concern when you were talking about this last summer, is there was too much passive investment money in the market and it skewed things. It pulled things north, and then once things started collapsing, it pulled things south, and so consequently there was too much volatility.

So I will just get you to think about this. Suppose there are just ten players in the market and five of them are tradition speculators, market makers, whoever you want, the gamblers we have all approved of, coming into the market, providing liquidity and consequently lower spreads, better target prices. Price discovery works better with that. Let's say there are a total of ten, and five of them are passive—"invesculators" is the term that was used yesterday— and things are working okay with just the five and five.

Then more passive folks show up. And let's say they are all at their limits. And let's say 50 more passive people show up, because this is now exciting. People have gone out and sold the deal and they are passing through the position limits to the entities or the individuals, so there are tons of them out there. There are not that many traditional speculators, but there are tons of the rest of these folks.

So what happens is 50 more show up. Now you have five traditional speculators hitting their position limits and 45 passive folks hitting their position limits. They are all being treated equally, but the market is being skewed like heck from the perspective of the individuals who want to use that market to hedge their crops, *et cetera*. So I don't think that works.

I think you need to think about something other than pure equality as the tool for meeting the objective that you have had. I would just ask you to think about that and maybe respond in writing, because it too complicated really to get into here, if that is okay with you.

Thank you, Mr. Chairman.

Mr. BOSWELL. Mr. Conaway.

Mr. CONAWAY. Thank you, Mr. Chairman. And your passionate, heartfelt call to a higher self earlier, I appreciate that. I have seven grandkids, and I don't believe they can afford the things that we have been doing as of late, going back several years, not just currently.

Mr. Taylor, the cotton contract: There has been some comments that there are some flaws in that contract that would or would not be addressed in this legislation that helped contribute to the widening basis last year. Can you respond to that?

Mr. TAYLOR. I can. I think the major issue with the March event had to do with the margining. Really the contract is fine. We have great convergence, we have a lot of deliverable space, and actually after the event it came back pretty quickly to where it needed to come. But it is particularly, I think, the issue that is setting a limit. Allowing the daily trading limit or not allowing the synthetic trading and then margining to that synthetic trading was the problem that really caused that.

Mr. CONAWAY. Does this bill address that? Should this bill address that?

Mr. TAYLOR. No, I think that needs to be addressed directly with ICE and the exchange. I don't think the bill needs to address that.

Mr. CONAWAY. Mr. Short, on what is referred to as the Balls Clause in the U.K. with their FSA, does section 3, do you think that is going to trigger that retaliation? Is it too strong?

Mr. SHORT. It is certainly possible. I think just in terms of the issue of working with foreign regulators and the whole debate about whether business could go overseas, we are certainly not suggesting that there should be a race to the bottom. I think this is a global financial crisis. It is a global problem.

What I am suggesting is that we affirmatively work with foreign regulators to adopt appropriate standards, and in all candor the United States will have to maybe begrudgingly accept that there are some legitimate different points of view out there on how markets should efficiently operate. I just worry that without the proper amount of coordination with foreign regulators, this is the type of thing that could be viewed as, well, this is the United States doing what it always does. It is our way or the highway, and the rest of the world can do whatever it wants.

I think really to solve problems in a global marketplace, you need to cooperate, and get to the right standards, and then adopt appropriate laws.

Mr. CONAWAY. I guess anybody on the panel in the time remaining, rather than mandating clearing, which is obviously something we could do, are there ways that we can promote clearing that would be quicker and more efficient perhaps, allowing the market to figure that out, as opposed to some uninitiated Members of Congress trying to figure that out?

Mr. PICKEL. I think the industry is in dialogue with regulators, both here in the U.S. and in Europe. This is related to credit default swap clearing. The New York Fed, as you probably know, over the last 3½ years has brought the industry together, the major firms, to talk to them about operational aspects of credit default swaps. And they have actually extended that beyond to interest rates and equity. And in those discussions, certainly on the credit default swap front, but potentially in other areas, there will be greater encouragement of clearing, although not a mandatory requirement for clearing. So I think that group is exploring that. Then over in Europe, similarly, there is an effort to introduce clearing there.

One of the issues there that relates to this whole question of pushing here and what that affects over there, the Europeans perceive that the initiatives through the New York Fed regarding clearing were moving in a direction of all the clearing happening in the United States. Actually, if you talk to CME or ICE or others who are proposing clearing, they want to be able to be a global clearing. So it was U.S.-based or U.S.-initiated, but it was a U.S. solution. But the Europeans are very much focused on the fact that they want to have a European clearinghouse for European transactions, and we see some of that protectionism, if you will, almost playing out in those debates. So that is an area of concern for the industry.

Mr. CONAWAY. Anyone else, Mr. Masters, on promoting clearing rather than mandating it?

Mr. MASTERS. I think you have to mandate clearing and you have to be pretty strong with that. And the reason you have to is because people aren't going to clear unless you mandate it. There are lots of folks out there, hedge funds in particular, that will not clear if you don't mandate it. If you mandate it, they will; but if you don't, they won't. Why should they?

Mr. CONAWAY. Well, there was a lot of money lost over the last 6 or 12 months, money made as well, and a lot of hedge funds lost a lot of money in the arena. So they don't get paid to lose money, I don't think, but maybe they do.

Thank you, Mr. Chairman. I yield back.

Mr. BOSWELL. Thank you. Last but not least, but maybe the best, Mr. Massa from New York.

Mr. MASSA. Thank you, Mr. Chairman. Let me just observe for the record, sir, there are no forces in the universe that could entice me to change party affiliation for the opportunity of asking a question earlier.

I am the most junior Member of Congress, sometimes referred to as Nancy Pelosi's bookend. However, I am struck by the erudite and intellectual nature of the conversation today. It befalls upon me to mention to you that I have hundreds of constituents in my district, where it is 14 degrees outside back home, and because of the failures cumulatively of this entire industry, will not be able to fill up their propane tank and may end up having to either go cold, move into assisted living, or otherwise have their lives destructed or destroyed by what we are talking about today. This is not some ethereal pie-in-the-sky conversation. It has incredible impact.

So to Mr. Masters, I would like to comment to you that when you talk about the speculative nature of the markets, I would say that much of what we have seen in the past 8 months is not speculative. It is either unethical, immoral, destructive or in fact criminal. And if it is not criminal, it should be; and I take these matters as very, very seriously.

Certainly Mr. Short, if you could respond to my quick question in writing, you made the statement there is nothing more accurate than the forces of the market in predicting the future.

Considering the nature of what we have seen in the past 18 months, if you would be willing to send me a letter with some of those predictions, I would welcome that, if for no other reason than to participate in the success of those predictions. Because frankly, from where I sit back home, the market has gotten it abjectly wrong across the border in virtually every sector. Not only as it was subject to false inflationary, but also the crash that followed, that is again infecting my constituents with a sense of doom, and has led to the United States losing incredible market share. I would welcome a letter on that topic from you, sir, if you could.

Last, or next to last but not least, Mr. Pickel, you stated should we make an action or act illegal? We should perhaps do that because we would see those markets move overseas, implying that the act of finding illegal activity is justified because somebody else is just going to do it.

Mr. MARSHALL. Mr. Chairman, the gentleman's microphone isn't on.

Mr. MASSA. This will be a technical test.

The CHAIRMAN. Why don't you move to the next microphone?

Mr. MASSA. We have great agility in our ability to shift.

The point being, sir, you said just because we think it is illegal, we should tolerate it, because it might move overseas. If you could give me an example, singularly or in numerous quantities, of things that this country, based on our value systems, think that are illegal that we have made illegal, that you think we should bring back here because it is being processed or conducted elsewhere in the world, I would love to consider those options.

I happen to believe that is a specious argument, and that it is the requirement of this argument to ferret out potentially illegal activity and protect the citizens of this nation. So if you would be willing to engage in a conversation in writing with me on that, I would very much welcome that.

Last, not many people understand out of New York how badly New York has been hit by our current financial situation. I am honored to know that Chairman Morelle has been at the forefront of the forensic investigation as to many of the things that have happened. We heard here today a lot of what did not contribute to the failure of AIG.

Mr. Morelle, in 1 minute or less, and then perhaps followed up under a special hearing, could you tell me what you think the factors are that did in fact cause the AIG crisis?

Mr. MORELLE. Well, thank you Congressman. I just would point out, as I mentioned in my testimony, that if you look at AIG from the perspective of the state-regulated companies, AIG has many state-regulated insurance subsidiaries. In New York alone, the property and casualty companies that come under AIG have roughly a $20 billion surplus that is robust, policyholders have been protected, and the experience has been similar in other states.

And to Congressman Marshall's point earlier about regulatory arbitrage, I will respond in writing and I appreciate the question because it is an important one. But I do note that the experience was similar across other states in the countries that have subsidiaries of AIG.

You contrast that with the financial services arm of AIG, unregulated, and by virtue of the Commodity Futures Modernization Act unregulated by the states and by the Federal Government. Their great exposure to credit default swaps in particular and their inability to manage risk, as Mr. Pickel indicates, the lack of ability to be able to quantify risk, and obviously other mark-to-market rules, *et cetera,* exacerbated their problem. To me that serves as a great contrast between those that take seriously the notion of financial guaranty and underwriting standards, *et cetera,* and the unregulated marketplace.

I would just say in closing, it is also noteworthy that under state regulations, we would not allow in New York, for instance, or any other state, the surpluses at the regulated subsidiaries to flow upward to provide support for AIG's financial services company, because it would have jeopardized the financial commitments that they had made to policyholders, and we hold that very dear at the state level.

Mr. MASSA. Well, Mr. Chairman, thank you very much for your testimony today, and I commend and recommend to the other Members of this Committee liaison with you, as you have delved so deeply into this in the State of New York.

Mr. Chairman, let me just conclude by saying I associate myself with great enthusiasm and vigor with Mr. Boswell's remarks. I find nothing inappropriate with emotion and vigor in defending the interests of the people we represent, and I yield back the balance of my time.

The CHAIRMAN. I thank the gentleman.

The gentleman from California, Mr. Costa, do you have any questions? We are just about at the end of this panel.

Mr. COSTA. Thank you, Mr. Chairman.

I don't know if it was covered while I was out of the room, but it dawned on me while listening to Mr. Master's testimony earlier, that you spent a great deal of your time discussing excessive risk and trying to put some parameters on excessive risk as you expounded on in your testimony. And I am trying to get a better handle on how you define "excessive risks."

Obviously there has been a lot of support in testimony today for the proposed legislation that the Chairman has introduced, and there has been also critiques argued by Mr. Pickel and others as to the potential impacts if such legislation is implemented.

But could you respond?

Mr. MASTERS. Sure. In the bill, in terms of defining what position limits should be, there is a sort of principle that was really developed by Franklin Roosevelt in the first Commodity Exchange Act, and that was there is something called "excessive speculation." There is not just manipulation, there is excessive speculation. And that only applies to commodities futures markets, it doesn't apply to other markets.

The reason it applies to commodities futures markets is because these markets used to be dominated by physical hedgers, and they are there for them to price risk. That is why we have commodity futures markets. We have a different regulator. We have a different way of looking at the markets, because these are commodities. They are not interest rates. Nobody goes home and eats a bowl of interest rates.

Mr. COSTA. We understand that.

Mr. MASTERS. So the idea is, this is a different kind of situation, so limits apply at each commodity. And the way the bill is structured, there would be an advisory panel made up of physical hedgers that would suggest position limits. By the way, exchanges would not be included, because exchanges have a built in conflict of interest to have the highest limits possible because they want volume on the exchange.

So what we need is sufficient speculation to provide the needs of Mr. Taylor and his constituency, and other kinds of constituencies, in the futures markets to provide liquidity that physical hedgers need. We need some speculation, but not too much speculation, not excessive speculation.

And the idea would be that since these markets are for physical hedgers, that a panel of physical hedgers would be best justified in setting the limits. After all, they are not going to cut off their nose to spite their face. They also want enough liquidity. But they don't want the markets driven by excessive speculation where their markets lose all reality of supply and demand forces in their market. They just want them big enough.

Mr. COSTA. You believe that the transparency of this commission would suffice in determining what would be viewed as an acceptable risk *versus* an excessive risk, because, unlike the commodities exchange that we are talking about, whether it be pork bellies or whether it be other future markets in agricultural commodities, in these instruments that we are talking about here, as you said, you can't eat a bowl of derivatives, I guess.

And so, where has this worked in a way that there is previous practices that we could draw from experience on?

Mr. MASTERS. The nice thing about position limits is we have 7 years of experience with them. Before the CFTC excluded some broker dealers, it basically exempted them from position limits. Before the Commodity Futures Modernization Act, which allowed swaps and other over-the-counter derivatives to be created that would allow broker dealers to trade off-exchange in significant fashion with other speculators. That is the loophole we have talked about in the past, before we had those issues, we had a very solid, working commodity futures market that served the needs of producers for years and years.

In fact, in 1998, producers, physical hedgers, and consumers of commodities were the dominant force of the market. They were 70 percent of the market. Speculators were about 30 percent.

Mr. COSTA. My time is almost expired. I don't know, do any of the others of you care to comment?

Mr. SHORT. I would just like to add one comment. I do think Mr. Masters is right that the original focus of position limits in the Commodity Exchange Act in its original form was to protect farmers who were growing their crops and needed to hedge.

But it is an interesting question depending on which side of the table you happen to be on, as far as being a net producer or a net consumer of something. I would just ask people to contemplate global oil. We produce very little global oil in this country. We are a massive consumer of it. If you really want to have the producers setting the price, aren't you giving the fox the keys to guard the henhouse?

Speculators keep those prices in line. And it is a more complex question than just saying that we need to hand it back over to the physical side of the market.

Mr. COSTA. Well, my time is expired, but you touched on kind of a sensitive nerve there. I mean, a number of people argue that, in part, the whole reason we had the tremendous increase last summer of oil prices was because of a great deal of speculation that took place. How did that protect the consumer in America?

Mr. SHORT. If I can answer that question with your indulgence, these are futures markets, and they are trying to predict. And no one can accurately predict the future.

Mr. COSTA. I understand that. But you had people making profits on the upswing and on the downswing, related to the whole oil futures market.

Mr. SHORT. That is right. And markets don't always operate with perfect——

Mr. COSTA. And our consumers paid the price.

Mr. SHORT. Markets don't always operate with perfect efficiency. But you could go back to some of the statements by people who were saying that the real price of oil should be $70 or $80 a barrel. It now happens to be $40 a barrel. So are we suggesting that we should raise the price of oil?

I mean, markets won't get things right all the time, but they will get them more right than they will wrong. And, it is just a very slippery slope, in my mind, if you are trying to micro-manage a market. Because, ultimately, I think what those markets did—speculators got us to a market equilibrium faster than we otherwise would have. I don't like the price of oil being high, but it got there ultimately because of physical market conditions.

Mr. COSTA. My time has expired. Thank you very much, Mr. Chairman.

The CHAIRMAN. Well, I thank the gentleman.

And, I may have been where Mr. Short was, but I have to tell you we had all this money come into the market and the price went up, not in only oil but wheat or whatever. When the financial crisis hit and all the money left, the prices went down significantly.

I believe oil is too cheap at $40. It is causing this country a lot of problems. So it has not only been a problem on the top side, it is a problem on the bottom side. We are going to kill off the renewable fuels industry and other things that we are trying to get going in this country, because of all this volatility. So that is a big concern on the part of this Committee.

And Mr. Costa said you can't eat derivatives. Mr. Frank has said that he wants to change the jurisdiction so that we only have jurisdiction over things you can eat, and their Committee has jurisdiction over things you can't eat. I would suggest that what is going on here is we are forcing the taxpayers to eat a lot of new debt and a lot of stuff that we are talking about.

So I would make the argument that because of that, we do have jurisdiction over this. Because we are forcing the American people to eat a lot of stuff here that they don't particularly like, but they are eating it, whether you like it or not.

Mr. Marshall has one last thing. And we are going to have a vote here in just a minute, and then we are going to dismiss this panel. We are going to go vote, give you guys a little bit of break, and we will take the second panel as soon as the vote is over.

So, Mr. Marshall, you are recognized.

Mr. MARSHALL. Thank you, Mr. Chairman.

And, Mr. Pickel, one more thought. You described CDSs as not being at fault for the mess we are in at the moment. But a number of people suggest that the availability of CDSs, the lack of transparency, the lack of required margining, and things like that are the problem. While the instrument itself is a good thing, the interwoven nature of exposure that has occurred with the major institutions where nobody can really tell what is going to happen next has caused investors to sit by the sideline, and has caused our money supply essentially to collapse dramatically. And CDSs are a large part of what has caused this interwoven "almost unfathomable to the individual institution, let alone outsiders who are trying to figure out what is going on" nature of our banking system right now.

And so, if that is the case, maybe in your response on the record to the Committee, a written response—if you would send a copy to me, I would appreciate it—you could describe a future where we have solved that problem so that people do understand the exposures of these large institutions and, consequently, can comfortably invest or not invest instead of just sitting on the sideline, frightened, because you just cannot tell what the heck is happening. And, largely, it is derivatives and swaps that cause that dilemma for so many investors and for the institutions themselves. If you would.

Mr. PICKEL. We certainly will respond in writing to that question.

Obviously, "transparency" is in the name of the Act; it is a very important issue to focus on. And there are several different aspects of transparency. One is the parties who engage in the transaction, whether they have the information available to decide whether the price is correct or not. I think in the CDS space, there is a great deal of transparency there.

Transparency of the regulators is critical. A lot of the institutions who are engaging in this business are regulated. To the extent that there needs to be more information to the regulators or more involvement of the regulators in understanding that, by all means we should explore how that can be more effective.

Also, there is transparency just generally to the public. And there are some steps that the industry has undertaken recently to provide more information about the amount outstanding on any particular reference entity or index. And that is information that is provided through this warehouse that the Depository Trust and Clearing Corporation has established.

So there are steps in that direction. And I think that those are the types of things, in response to your earlier comment, that we ought to be working on as an industry and working together with this Committee to identify those additional means of transparency.

Mr. MARSHALL. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

I would just observe how far the debate has come. Because, when we started all of this, the argument was that this transparency was not necessary and was not good. So we have made some progress. We apparently now have everybody to the point where they at least agree on that part of things, which is better than where we were 8 months ago.

The gentlelady from Ohio, do you have a question?

Mrs. SCHMIDT. Not at this time.

The CHAIRMAN. Okay. Welcome.

With that, we appreciate the panel's testimony and involvement. It has been very helpful. We appreciate your patience. And we will dismiss this panel.

I think we are going to vote here shortly. It is only one vote, and I would encourage Members to vote and come back. And, staff, if you could have the other panel ready to go when we get back, we will proceed with the second panel.

I thank you again.

[Recess.]

The CHAIRMAN. The Committee will come back to order.

I would like to welcome our second panel of witnesses: Mr. Chris Concannon, Executive Vice President of NASDAQ OMX, New York; Mr. Bill Hale, Senior Vice President of the Grain and Oilseed Supply Chain, of Cargill; Mr. Karl Cooper, Chief Regulatory Officer of New York Stock Exchange Liffe, on behalf of NYSE Euronext; Mr. Paul Cicio, President of the Industrial Energy Consumers of America.

And is Mr. Brickell here? He is just out? Okay. He is from Blackbird Holdings of New York and will be back.

So welcome, all of you, to the panel. Thank you for your patience. We are working through this as best we can. And your full statements will be made a part of the record. Feel free to summarize.

And, Mr. Concannon, you are up first. And welcome to the Committee.

STATEMENT OF CHRISTOPER R. CONCANNON, EXECUTIVE VICE PRESIDENT, TRANSACTION SERVICES, NASDAQ OMX, NEW YORK, NY

Mr. CONCANNON. Thank you, Chairman Peterson, Ranking Member Lucas, and other Members of the Committee, for the invitation to speak today on this important legislation.

You may be wondering why NASDAQ OMX, the operator of the largest equities exchange in the world, is testifying on OTC derivatives. Well, we currently own and operate 17 markets and eight clearinghouses in trade equities, fixed income, derivatives, and energy products around the globe.

While I must admit that we have some self-interest in the reform of OTC derivatives, our interest is the product of almost 4 decades of experience in delivering efficient and transparent markets to investors. Over the past several years, trillions of dollars of investment instruments have been crafted through an unregulated web of interconnected counterparty relationships. Because these instruments are not valued in a transparent, efficient market with the opportunity for centralized clearing, unrecognized risk continues to be piled upon unrecognized risk.

We at NASDAQ are confident of the beneficial effects of centralized clearing, transparency, and regulation for the OTC markets. It is possible to transform an OTC market to one that is centrally cleared and visible to all. We have done it. When NASDAQ was founded 37 years ago, our primary mission was to bring order, discipline, and fairness to the over-the-counter equities market.

What we know from our experience is simple yet revolutionary for this market. These OTC instruments need to be centrally cleared to better distribute or mutualize the risk. Central clearing fundamentally means more parties are backing a transaction *versus* one or just a few.

NASDAQ OMX recently became the majority owner of the International Derivatives Clearing Group, IDCG, a CFTC-registered clearing organization. IDCG has developed an integrated derivatives trading and clearing platform that will allow members to convert their OTC interest rate swaps into a cleared future product with the full benefits of centralized clearing.

Building on decades of experience, NASDAQ OMX is bringing the values of organized markets, including central clearing, standardized margin, transparency, and real valuations, to what is a $458 trillion interest rate swap market. While there has been much discussion around the CDS market, you should be aware that the interest rate swap market is six times larger.

IDCG is live today, operating a highly efficient market to clear and settle U.S. dollar-denominated interest rate swaps. I must commend the CFTC for its thorough review and professional timeliness in approving IDCG's operation December of last year.

Thus, NASDAQ OMX is highly supportive of provisions in section 13 of your legislation that would protect our financial system and investors by requiring most OTC derivatives to be settled and cleared. In addition, we support the need to set some limited exemptions for derivatives that may contain complex contractual aspects rendering them inappropriate for clearing.

Let me highlight one benefit of central clearing of interest rate swaps within the banking system. Current regulatory capital treatment for derivatives applies a higher capital charge for bilateral uncleared holdings. Simply, under accounting rules and international treaties such as BASEL I and BASEL II, bilateral trading of OTC derivatives introduces systemic risk while creating an extremely inefficient use of capital. We believe the entire financial system would benefit from a large capital infusion as a result of simply mandating centralized clearing.

Capital efficiency is also greatly enhanced by the process of netting. With central clearing, financial institutions can net out their positions across the entire market and further reduce their required capital reserves, while at the same time reducing the complexity and risk of the bilateral world.

We also support the efforts by the Federal Reserve, the FDIC, and the Office of Comptroller to evaluate the need for enhanced regulatory capital charges for non-cleared OTC transactions. We think that customers that use these derivatives should also demand that their transactions be subjected to clearing. According to a recent *Bloomberg* story, several State Attorneys General are investigating the opaque fees several local governments paid to obtain interest rate and other derivatives to hedge swings in borrowing costs for schools, states, and cities.

We know that the larger issues of financial regulatory reform are beginning to receive consideration. We believe that it is important to apply modern regulatory concepts like principle-based regulation, practiced successfully by the CFTC and regulators around the world.

Finally, we must be mindful that these OTC instruments ignore international borders. So we agree with President Obama that these issues cannot be handled with domestic action alone. For many reasons, working through multilateral structures like the G20 will ensure that global markets work together in what is a global problem. In this way, we will ensure that regulatory arbitrage is minimized and market participants are not driven to engage in jurisdiction shopping.

Again, thank you for the invitation. I am happy to take questions.

[The prepared statement of Mr. Concannon follows:]

PREPARED STATEMENT OF CHRISTOPER R. CONCANNON, EXECUTIVE VICE PRESIDENT, TRANSACTION SERVICES, NASDAQ OMX, NEW YORK, NY

Thank you Chairman Peterson and Ranking Member Lucas for the invitation to speak to you this morning regarding your legislation, the Derivatives Markets Transparency and Accountability Act of 2009.

Some of you may be wondering why NASDAQ OMX, the operator of the world's largest cash equities exchange, is testifying regarding OTC derivatives. Well, NASDAQ OMX owns and operates 17 markets and eight clearing houses around the globe. Our markets trade equities, derivatives and fixed income products. Not only do we pride ourselves in operating our markets efficiently, but we are exceptionally proud of the efficiencies that we have delivered to these markets. In regards to OTC derivatives, I will admit that we have self interest in the reform of these markets. But this self interest is the product of almost 4 decades of experience in delivering efficiency and transparency to the financial markets.

When we examine your legislation we see a policy initiative that will bring fundamental change to a market that is defined by counterparty risk, unknown systemic risk and opaque markets. While we continue to deal with the worst financial crisis since World War II, we can't simply wait for it to end before we study and implement needed reforms. Reforms can and should be implemented now.

As your legislation recognizes, over the past several years and throughout the economy, trillions of dollars in investment instruments have been crafted through an unregulated web of interconnected, counterparty relationships. Even after all the billions in Federal subsidies, the books of banks and businesses are littered with these complex instruments whose value is opaque and potentially mispriced. These particular credit instruments continue to be traded in what's known as the over-the-counter or OTC market. Because these instruments are not valued in a transparent, efficient market with the opportunity for centralized clearing, unrecognized risk continues to be piled upon unrecognized risk.

The negative aspects of the over-the-counter market have been documented well by the hearings of this Committee. There is no need to further expand on those findings. It is now time to implement change both by government action and by the markets themselves.

The markets and clearing houses that sit before you today are here to explain how our markets worked throughout this horrible crisis. Very few people can sit before Congress today and explain how their systems discovered prices everyday; how their clearing houses absorbed the impact of major defaults such as Lehman; or how they were able to settle each and every trade. We represent the markets that worked while the OTC markets represent the opaque market that tied these unsuspecting victims into a complex web of financial disaster. The point is—centralized clearing worked as designed and it worked in many asset classes around the globe.

We at NASDAQ are confident of the beneficial effects of centralized clearing, transparency and regulation for the OTC markets. NASDAQ made its name by being a pioneer in the over-the-counter cash equities market. Until NASDAQ came on the scene, the cash equities market also once operated similar to the current OTC derivatives market.

NASDAQ was born out of a need to share information about stock trading in a central fashion, accessible to all, with a system designed to protect investors and facilitate discovery of the right price for each stock. We continue to operate on a simple principle that is the foundation of all markets: An informed and willing buyer and an informed and willing seller agreeing to trade is the best valid price discovery mechanism.

It is possible to transform an over-the-counter market to one that is centrally cleared and visible to all. We have done it; when NASDAQ was founded 37 years ago our primary mission was to bring order, discipline and fairness to the over-the-counter equities market. What we know from our experience is simple, yet revolutionary for this market: These OTC instruments need to be centrally cleared to better distribute or mutualize the risk. Central clearing fundamentally means more parties are backing a transaction *versus* one or just a few. Centralized clearing gathers strength from more parties while delivering capital efficiency through the benefits of netting multiple risk exposures.

Building on the decades of experience, NASDAQ OMX is bringing the values of organized markets including central clearing, standardized margin, transparency, and real valuations to what the Bank for International Settlements estimates is a $458 trillion over-the-counter interest rate swap market. While there has been much discussion about the credit default swap market, you should be aware that the interest rate swap market is six times larger than the credit default swap market.

As you may know, NASDAQ OMX recently became the majority owner of the International Derivatives Clearing Group (IDCG). IDCG, an independently operated subsidiary of The NASDAQ OMX Group, has developed an integrated derivatives trading and clearing platform. IDCG is transforming the interest rate swap marketplace, allowing members to convert their OTC swaps into a cleared future product with the full benefits of central clearing. This CFTC approved platform will provide an efficient and transparent venue to trade, clear and settle interest rate swap (IRS) futures.

One of the most compelling attributes of our IDCG endeavor is that it allows for all forms of execution. We have the ability to allow customers the flexibility to operate their business as they have, but with an independent and standardized view of the risk. This independence is the absolute core of a centrally cleared market place. By concentrating its focus on risk, IDCG can be open to multiple forms of execution. This flexibility allows for more of the market to participate in an open and consistent manner while all of the risk is marked-to-market by the same benchmark.

I must commend the Commodity Futures Trading Commission (CFTC) for its thorough review coupled with professional timeliness in approving the application for IDCG to operate. With CFTC approval of IDCG's Derivatives Clearing Organization (DCO) license on December 22, 2008, IDCG is "live" today; operating a highly efficient market to clear and settle U.S. dollar denominated interest rate swap futures. We, along with IDCG, look forward to the day when vast parts of the over-the-counter market are no longer stored in the back-rooms of brokerage houses but are held in well-capitalized clearing houses transparent to all—including the regulators and public policymakers.

Thus, NASDAQ OMX is highly supportive of provisions in section 13 of your legislation that would protect our financial system and investors by requiring most OTC derivatives be settled and cleared. We believe this section is good public policy and hope to see it enacted into law. In addition, we support the ability of the CFTC to set some limited exemptions for derivatives that may contain complex contractual aspects rendering them inappropriate for clearing.

Let me offer one benefit of clearing in the interest rate swap space that will have an immediate and direct positive impact on the banking system. Current regulatory capital treatment for derivatives held by banks and other financial institutions applies a higher capital charge for bilateral, uncleared, holdings. If existing banks cleared their interest rate swap transactions through a central clearing house, significant capital would be released for the banks to apply to new lending or against other assets. Simply, under the current accounting rules, insolvency laws and international treaties (such as BASEL I & II), the current method of bilateral trading is not only less efficient—it is a more expensive use of capital.

We believe the entire financial system would benefit from a capital infusion as a result of mandating centralized clearing. To put it as succinctly as I can, centralized clearing reduces the market, counterparty, and operational risk of a portfolio. In addition, it can also reduce capital requirements that today, unfortunately, are often being supplied with non-performing taxpayer money.

Capital efficiency is greatly enhanced in conjunction with another benefit of central clearing: the process of netting. With central clearing, financial institutions can "net" out their positions across the entire market and further reduce their required capital reserves while at the same time reducing the complexities and risk of the bilateral world.

We also support efforts by the Federal Reserve, the FDIC and the Office of the Comptroller to evaluate the need for enhanced regulatory capital charges for non-cleared OTC transactions. We, at NASDAQ, believe it is critical that all forms of risk are appropriately priced, and that regulatory capital rules provide meaningful incentives to drive OTC derivatives on to central clearing houses.

We think that customers that use these derivatives should also demand that their transactions be subjected to clearing. According to a recent *Bloomberg* story, several State Attorneys General are investigating the opaque fees several local governments paid to obtain interest rate and other derivatives to hedge swings in borrowing costs for schools, states and cities—fees which were more difficult to challenge when neither information about execution pricing nor pricing of risk were publicly available. Certainly, if state and local governments adopted the mandate to only transact cleared products, the trend for clearing would be enhanced. The *Bloomberg* article is an addendum to my written testimony.

We know that the larger issues of financial regulatory reform are beginning to receive consideration by you and your colleagues here in Congress. While we don't have detailed views on regulatory reform, we believe the key concept to keep in mind is to apply modern regulatory concepts like the principles-based approach to regulation practiced successfully by the CFTC and regulators around the world. We hope that the process of updating U.S. regulation will retain the CFTC's principle-based approach and expand that approach throughout our regulatory framework where appropriate.

Mr. Chairman, NASDAQ OMX supports your interest in prohibiting over-the-counter trading of carbon offset credit futures. NASDAQ owns a carbon trading facility in Europe called NordPool. NordPool was the pioneer in carbon products—the first exchange worldwide to list carbon allowances (EUA) and carbon credits (CER). And, although NordPool is the number two marketplace for carbon in Europe, 70%

of all trading now takes place in the OTC space, away from effective regulation and supervision. Therefore, it is impossible to know the exact volumes that are traded. Our experience in Europe suggest that the opaque use of OTC derivatives in the European Cap and Trade experiment contributed to the chaos and failure of that marketplace. We want NordPool to be part of the U.S. market solution for greenhouse gas emission reductions and look forward to working with you and the Committee towards ensuring that your legislation allows that expertise to be part of the equation.

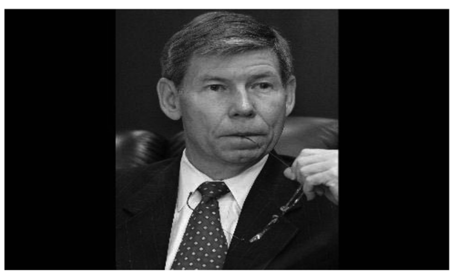
Finally, Mr. Chairman, we must be mindful that these OTC instruments ignore international borders and jurisdictions. So we agree with President Obama that these issues can not be handled *only* with domestic action. For many reasons, working through multilateral structures like the G20 will ensure that the global markets work together on what is a global problem. In this way we will ensure that regulatory arbitrage is minimized and market participants are not driven to engage in "jurisdiction shopping." We understand that President Obama hopes to make these issues, and a coordinated global response, a key aspect of the G20 meeting in April and NASDAQ OMX supports the President's leadership on this matter.

Again, thank you for inviting NASDAQ OMX to testify and for your efforts to bring transparency and order to these important marketplaces. We look forward to working with you and the full Committee membership as you seek to tackle these important public policy challenges.

ADDITIONAL EXHIBIT

California Probes Muni Derivatives as Deficit Mounts (Update1)

By WILLIAM SELWAY and MARTIN Z. BRAUN



Jan. 23 (Bloomberg)—California is investigating whether Wall Street banks and financial advisers conspired to overcharge local governments for derivative contracts tied to municipal bonds, a state official said.

The antitrust investigation, with Connecticut and Florida launching similar efforts, follows inquiries by the U.S. Justice Department and class action lawsuits by cities from Oakland to Baltimore. They claim banks and advisers cost taxpayers money by rigging bids or fixing prices on financial contracts.

The investigations center on the investments that schools, states and cities buy with the proceeds of some of the $400 billion of municipal bonds they sell annually and on the interest-rate swaps designed to guard against swings in borrowing costs, authorities have said. Financial advisers are hired to solicit bids for the investments and to determine if their government clients pay fair rates in swaps, which are unregulated instruments not traded on exchanges.

States "almost have no choice but to join in because it involves their towns and cities and maybe even the states themselves," said Christopher "Kit" Taylor, the former executive director of the Municipal Securities Rulemaking Board, the municipal bond industry regulator. "They're sitting there saying this is a situation where we may have been taken."

Continuing Probes

Christine Gasparac, a spokeswoman for California Attorney General *Jerry Brown,* confirmed California's participation. She declined to comment further. The probe comes as the most populous U.S. state and the biggest issuer of municipal debt struggles to close a record $42 billion deficit through next year and faces credit rating cuts on $67 billion of debt.

Connecticut has had a continuing probe. "Our investigation is active and ongoing," Connecticut Attorney General *Richard Blumenthal* said in a statement.

Florida Attorney General *Bill McCollum* has sent out 38 subpoenas asking firms for information on sales of derivatives, including guaranteed investment contracts, where governments place money raised from bond sales until it is needed for projects, said Sandi Copes, a spokeswoman for McCollum.

Among the documents Florida requested were bids and communications between the firms and financial advisers related to the purchase or sale of municipal derivatives, according to the subpoena.

Copes declined to comment further, citing the pending investigation.

U.S. prosecutors and the Securities and Exchange Commission have searched for more than 2 years for evidence of collusion between banks and brokers to overcharge cities, states and local government agencies.

Winning Leniency

In February 2007, Charlotte, North Carolina-based Bank of America Corp. was granted leniency by the Justice Department for its cooperation in a national investigation of bid-rigging and price fixing involving municipal derivatives.

In exchange for voluntarily providing information and offering continuing cooperation, the Justice Department agreed not to bring criminal antitrust charges against the bank.

Derivatives are contracts whose value is derived from assets including stocks, bonds, currencies and commodities, or from events such as changes in interest rates or the weather.

"This is a trillion-dollar market, and this goes back to the 1980s," said *Michael D. Hausfeld,* an antitrust lawyer representing municipalities, including Fairfax County, Virginia, in a class-action case against 30 banks.

Rigged Bids

Investigators are looking into whether bidding for guaranteed investment contracts was rigged. U.S. Internal Revenue Service rules require that the agreements be awarded by competitive bidding from at least three banks.

Eight California municipalities, including Los Angeles, Fresno and San Diego County, filed civil class-action, or group lawsuits. The suits, most of which were consolidated with others in U.S. District Court in New York City, allege that banks colluded by deliberately losing bids in exchange for winning one in the future, providing so-called courtesy bids, secretly compensating losing bidders and allowing banks to see other bids.

Brokers participated in the collusion by facilitating communication among banks and sharing in illegal profits, the civil class-action suits allege.

Three advisers to local governments, CDR Financial Products Inc., Sound Capital Management Inc. and Investment Management Advisory Group Inc., were searched by the FBI in November 2006. More than a dozen banks and insurers were subpoenaed and former bankers at New York-based JPMorgan Chase & Co., *Bear Stearns & Cos.* and UBS AG of Zürich were advised over the past year that they may face criminal charges.

New Mexico

Now, Federal prosecutors are investigating whether New Mexico Governor *Bill Richardson*'s Administration steered about $1.5 million in bond advisory work to CDR, which donated $100,000 to Richardson's political committees.

CDR also advised Jefferson County, Alabama, on more than $5 billion of municipal bond and derivative deals. A combination of soaring rates on the bonds and interest-rate swaps is threatening the county with a bankruptcy that would exceed Orange County, California's default in 1994. Jefferson County paid JPMorgan and a group of banks $120.2 million in fees for derivatives that were supposed to protect it from the risk of rising interest rates.

Those fees were about $100 million more than they should have been based on prevailing rates, according to James White, an adviser the county hired in 2007, after the SEC said it was investigating the deals.

CDR spokesman *Allan Ripp* has said the company stands by the pricing of the swaps and said White's estimates were incorrect because they didn't take into account the county's credit profile, collateral provisions between the county and the banks and the precise time of the derivative trades.

To contact the reporters on this story: *Martin Z. Braun* in New York at [Redacted].

Last Updated: January 23, 2009 09:34 EST

The CHAIRMAN. Thank you, Mr. Concannon.

Mr. Hale, welcome to the Committee.

STATEMENT OF WILLIAM M. HALE, SENIOR VICE PRESIDENT, GRAIN AND OILSEED SUPPLY CHAIN NORTH AMERICA, CARGILL, INCORPORATED, WAYZATA, MN; ACCOMPANIED BY DAVID DINES, PRESIDENT, RISK MANAGEMENT, CARGILL, INCORPORATED

Mr. HALE. Chairman Peterson, Ranking Member Lucas, Committee Members, thank you. My name is Bill Hale. I have been in the grain merchandising business with Cargill for 35 years. I am joined this morning by David Dines, who has managed our OTC business for the past 15 years. As a merchandiser and processor of commodities, the company relies heavily upon efficient and well-functioning futures markets.

First, I would like to thank the Chairman for holding this hearing and for his willingness to listen and address some of our concerns. We appreciate the changes made in the draft to better accommodate highly customized risk management products.

Cargill encourages policymakers to develop regulatory systems that foster efficient, well-functioning, exchange-traded and OTC markets for agriculture and energy products. This can best be achieved by establishing better reporting and transparency for market participants, establishing and ensuring enforceable position limits.

The existing draft of the Derivatives Markets Transparency and Accountability Act takes several positive steps, especially in the area of reporting, which will enhance the ability of the regulator to properly monitor market activities.

However, the draft bill has two areas of concern. Section 6, position limits which are not constructed in the same manner for exchange-traded and OTC markets. This can be addressed by modifying how position limits are structured. This is not a question of whether they should apply.

To put this in perspective, think in terms of highway speed limits. They apply to individual drivers. You do not send a car-maker a ticket when someone speeds. The same structure currently applies in the Chicago futures markets, and the same structure should apply in the OTC market.

The other area of concern is section 13, mandatory clearing, which will stifle activity in the OTC market and reduce hedging opportunities in the agricultural and energy markets. This can be addressed by increased reporting requirements for OTC providers.

While Cargill supports better reporting, transparency, and enforceable position limits, we urge caution and restraint for policymakers. We believe there is real danger in treating all over-the-counter products across all asset classes the same.

In addition, the changes needed to improve some commodity-specific exchange-traded markets, particularly wheat and cotton, are often contract issues that have to be resolved between the exchanges and the market participants. Legislative measures are poor instruments to resolve these specific issues.

Products provided by the OTC markets help hedgers, such as food, feed, industrial companies, meet risk management needs with tailored alternatives. Too often it is thought that the OTC market is solely used by speculators. However, it is critical to note that the majority of our OTC activity is for commercial and producer hedgers seeking tailored management solutions.

Most critically during this unprecedented volatility, systemic risk was avoided because of the availability of both OTC and exchange-based hedging tools. Given the stress on the markets, some weaknesses were exposed, and the bill seeks to address those areas. But much of the basic functionality of the agriculture and energy markets performed well.

It is important to remember that the dramatic volatility and price rise in 2008 was influenced by many variables. With strong fundamentals, commodity markets attracted many participants, both hedgers and speculators.

Regarding section 6, Cargill supports enforceable position limits for noncommercial participants. However, as it was designed in the draft bill, position limits are not applied in the same manner for the OTC market as they are in exchange-traded markets. They should be structured in a similar manner for both markets. The draft bill seeks to apply the same position limit to the OTC provider as it does to the noncommercial participant. This is too restrictive to the OTC provider, since its role is to serve as an intermediary to more than one customer. This restriction will limit the size of the OTC market beyond the intended noncommercial position limits. The Committee will be able to achieve its objective of ensuring position limits in OTC transactions by applying position limits to the noncommercial participants.

For section 13, we do not believe that mandatory clearing is needed. The stated benefits of central clearing are better transparency, reporting, and mitigation of counterparty risk. This can be accomplished efficiently by having standardized reporting requirements to the CFTC. The CFTC would have the ability to investigate and curtail any OTC customer whose position they believe is to large for the underlying commodity market.

Centralized clearing has a role and should be encouraged for financially weaker market participants. However, financially strong food companies, industrials, commercials, and producers should have the flexibility to negotiate credit terms. Removing this flexibility from both simple and tailored OTC products will greatly reduce hedging activity through the working capital requirements of margin. Changes to the current system would be occurring at a time when liquidity and credit are already constrained, and at a time when hedging should be encouraged.

Agriculture and energy OTC providers for many years have effectively used collateralized margining agreements and other credit support mechanism to manage credit and market exposures. This system works very well.

It was simple OTC swaps on the grains that helped enable Cargill and other grain buyers to reopen deferred grain purchases from the farmer during 2008. Had the bill been in place in its current form, Cargill and other grain buyers would have been unable to use simple swaps to mitigate the margin requirements imposed on futures hedges. As a consequence, farmers would have been further burdened by the lack of pricing and liquidity for their crops.

While the bill currently has provisions that allow for exceptions to centralized clearing for highly customized transactions, it is a little unclear to us what will and will not qualify for this exception. It is critical that no changes be made that would inhibit customized hedges, as this would also significantly reduce prudent hedging among market participants.

If you think of the futures contract as one type of product, Cargill has over 130 different types of OTC products. The hedging customer can choose to further tailor the protection time frame, price level, and transaction size. Given this, no two 0TC transactions are identical, which is why centralized clearing is problematic. Clearing organizations do not have the systems and processes necessary to value and clear a wide range of products with a high degree of customization.

In conclusion, Cargill appreciates the work of the House Agriculture Committee, ensuring that both exchange-traded and OTC markets perform well. These markets provide critical functions. This past year was clearly a volatile and difficult time for the commodity markets. Steps can and should be taken to improve market transparency and reporting, as well as ensuring that position limits are effectively enforced.

We have serious concerns about sections 6 and 13 in the draft legislation, but we are confident that we can work constructively with Members of the Committee to develop policy alternatives that will help ensure the integrity of the markets.

Thank you.

[The prepared statement of Mr. Hale follows:]

PREPARED STATEMENT OF WILLIAM M. HALE, SENIOR VICE PRESIDENT, GRAIN AND OILSEED SUPPLY CHAIN NORTH AMERICA, CARGILL, INCORPORATED, WAYZATA, MN

My name is Bill Hale, Senior Vice President, Grain and Oilseed Supply Chain North America. I am testifying on behalf of Cargill, Incorporated and have been in the grain merchandising business for 35 years. I am also joined this morning by David Dines, President of Cargill Risk Management.

Cargill is an international provider of food, agricultural, and risk management products and services. As a merchandiser and processor of commodities, the company relies heavily upon efficient and well-functioning futures markets. Cargill is also active in the energy markets, offering risk management products and services to commercial customers.

Cargill encourages policymakers to develop regulatory systems that foster efficient, well-functioning exchange-traded and over-the-counter markets for agricultural and energy products.

This can be best achieved by:

- Establishing better reporting and transparency for market participants.
- Establishing and ensuring enforceable position limits.

This past year was a period of remarkable volatility driven by many factors and, by large measure, the agriculture and energy commodity markets responded appropriately.

The existing draft of the Derivatives Markets Transparency and Accountability Act of 2009 takes several positive steps, especially in the area of reporting which will enhance the ability of the regulator to properly monitor market activities. However, the draft bill has two areas of concern:

- Section 6: Position limits, which are not constructed in the same manner for exchange-traded and OTC markets.
    - This can be addressed by modifying how the position limits are structured. This is not a question of whether they should apply.
- Section 13: Mandatory clearing, which will stifle activity in the OTC market and reduce hedging opportunities in the agricultural and energy markets.

- This can be addressed by increased reporting requirements for OTC providers and segmenting credit default swaps from traditional agriculture and energy contracts.

While Cargill supports better reporting, transparency and enforceable position limits, we urge caution and restraint for policymakers. The agricultural and energy over-the-counter markets are not the source of systemic risk and abuse that the credit default swap market has been. We believe there is real danger in treating all over-the-counter products across all asset classes the same.

In addition, the changes needed to improve some commodity-specific exchange-traded markets, particularly wheat and cotton, are very often contract issues that have to be resolved between the exchanges and the market participants. A well-informed regulator can be helpful in making sure balanced decisions are made that ensure contract functionality and market integrity, but broad legislative measures are poor instruments to resolve these specific issues.

Role of Commodity Futures Markets and Over-the-Counter Markets

The objective of a commodity futures market is to provide a price discovery mechanism and allow for effective risk transfer. For a commodity futures market to meet this objective, there must be both convergence with the futures price relative to the underlying cash value of the commodity at the time of delivery and a balanced range of market participants to provide adequate liquidity and efficiency.

In addition to buyers and sellers with a physical interest in the underlying commodity, speculators also play a vital role in enhancing liquidity and futures contract performance. In effect, they help bridge the gap between buyers and sellers and ensure that contracts are quickly filled with the least possible transaction costs.

Beginning with farmers and other commodity producers, and extending all the way through the supply chain to end-users, it is critical to have well-performing futures markets. Futures products allow farmers to know what their product is worth and to better manage their risks by setting a price for the commodity that is close to their actual delivery time. For consumers or processors, the same is true in allowing them to hedge their risks and gain greater certainty over their costs.

Products provided by the over-the-counter (OTC) markets help hedgers meet risk management needs with tailored alternatives that cannot realistically be provided by traditional commodity futures and options markets. Too often is it thought that the OTC market is solely used by speculators, however it is critical to note that a majority of our OTC activity is for commercial and producer hedgers seeking risk management solutions tailored for their business needs.

Unprecedented Commodity Market Volatility During 2008

During 2008, we experienced an unprecedented increase in commodity prices, only to be immediately followed by a decline of the same historical magnitude. This in itself has been tough for market participants to bear, but we now know that this has been followed by one of the worst economic crises in 80 years.

In the world of risk management, we often talk of stress events and this was one of epic proportions. No risk manager could have ever contemplated what the markets have just gone through. I mention this because if there was ever a test for the agricultural and energy futures and over-the-counter markets it was these past twelve months.

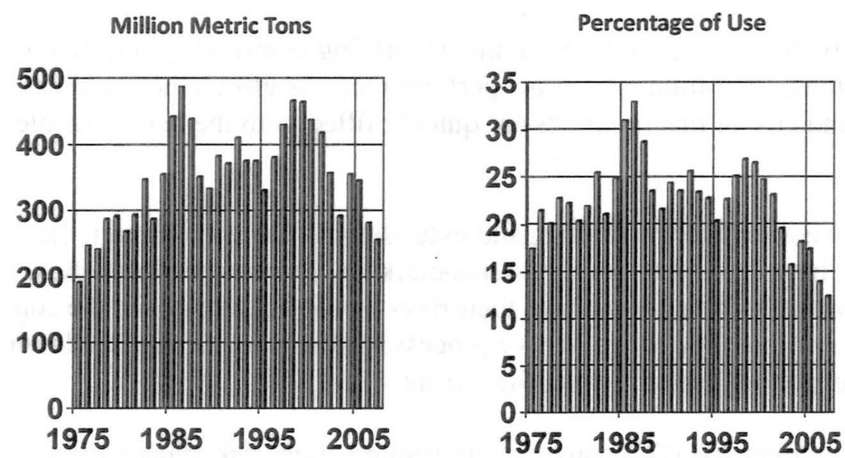
Fortunately, in many ways, these markets performed well as demonstrated by limited credit issues and limited contract defaults.

Most critically, during this unprecedented volatility, systemic risk was avoided because of the availability of both OTC and exchange-based hedging tools. Given the stress on the markets, some weaknesses were exposed and the bill seeks to address those areas, but much of the basic functionality of the agriculture and energy markets performed well.

Fundamental Factors Influencing Market Behavior and Speculation

It is important to remember that the dramatic volatility and price rise in 2008 was influenced by many variables. Ending stocks for many of the key commodities were tight. In wheat, for example global supplies had been reduced by 2 years of major drought in Australia, a major wheat exporter.

Global stocks of grain and key oilseeds



Source: USDA. Foreign Agricultural Service.

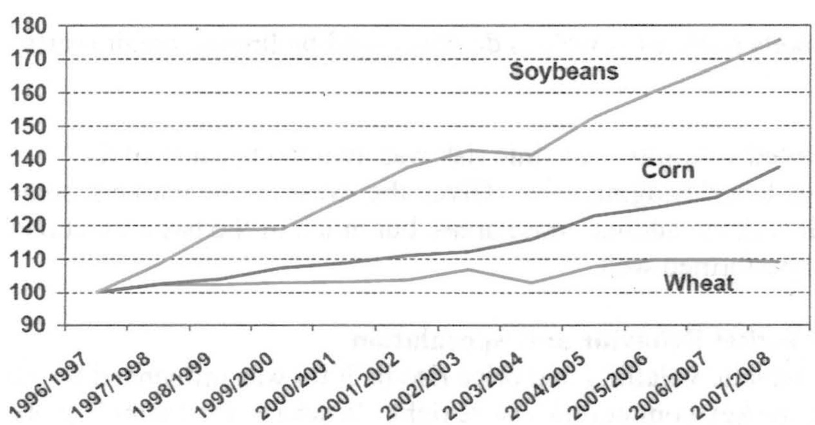
The ethanol mandate increased demand for corn. In response, producers planted more corn acres during the 2007 crop year and fewer soybeans, resulting in a very tight carryout balance for soybeans prior to the 2008 harvest.

Also on the demand side, projections for continued growth in China, India and much of the developing-world showed growing needs for many of the basic agricultural and energy commodities. These factors were widely known within the farming, trading, processing, and investing communities.

USDA Ag Outlook 2008

Projected Demand Growth

1996 = 100



Source: USDA.

With strong fundamentals, commodity markets attracted many participants, both hedgers and speculators, who believed commodity prices would rise. These fundamentals did not only attract capital to futures markets, but also attracted resources toward physical commodity production. Land costs increased for good quality farmland and producers stepped up investments in production technology through equipment, seeds and fertilizer.

It is also important to note that even exchange-traded markets with no index fund participation also experienced extreme volatility this year. The volatility and price movements of the Hard Red Spring Wheat contract traded at the Minneapolis Grain Exchange were especially dramatic. Prices rallied 500% from May 2007 through February 2008, reaching a high of $25 per bushel.

Derivatives Markets Transparency and Accountability Act of 2008

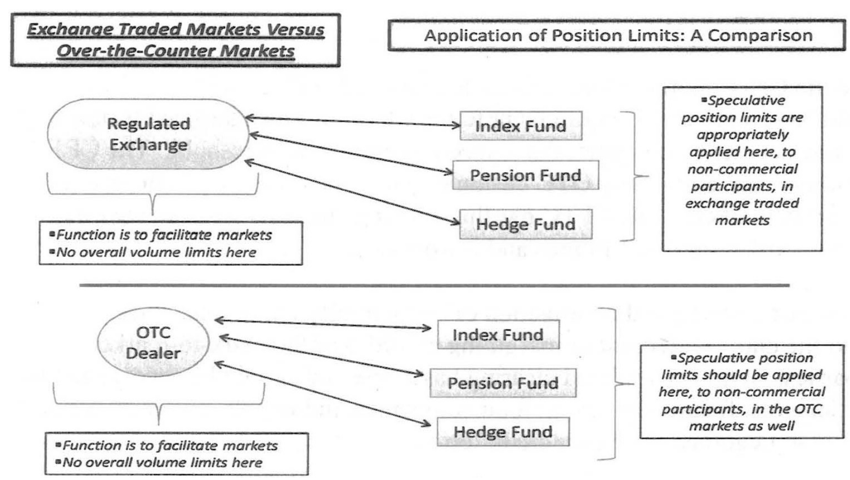
Cargill supports many of the components of the draft bill before the Committee today and appreciates the work of the Chairman. The bill would improve reporting and transparency. However, we are concerned with two specific areas under consideration by the Committee:

- Section 6, regarding how position limits may be applied to OTC product providers.
- Section 13, regarding mandatory clearing of OTC transactions through a derivative clearing organization.

Both provisions have negative unintended consequences.

Section 6: Application of Position Limits

Cargill supports enforceable position limits for noncommercial participants. However, as designed in the draft bill, position limits are not applied in the same manner for the OTC market as they are in the exchange-traded markets. They should be structured in a similar manner for both markets.



In exchanged traded markets, the clearing broker serves as an intermediary or aggregator of positions, just like the dealer does in the OTC market. Position limits are applied to noncommercial participants in exchange-traded markets and not to the clearing broker. Limits in the OTC market should be categorically applied in the same manner, only to the noncommercial participant and not the OTC provider.

The draft bill seeks to apply the same position limit to the OTC provider as it does to the noncommercial participant. This is too restrictive to the OTC provider since its role is to serve as an intermediary to more than one customer. This restriction would limit the size of the OTC market beyond the intended noncommercial position limits.

The Committee will be able to achieve its objective of ensuring position limits in OTC transactions by applying position limits to only the noncommercial participants. Addressing this issue in this manner will ensure enforceable position limits and continue the functionality of this segment of the market.

Section 13: Clearing of Over-the-Counter Transactions

- Substantial benefits can be achieved through better reporting by OTC providers.
- Segment the OTC market to focus on areas with the greatest challenges.
- Tailored risk management OTC contracts for hedgers cannot be cleared.
- Standardized swaps convey substantial benefits to a wide range of market participants and these benefits will be lost if clearing is mandatory.

A stated benefit of central clearing is better transparency and data reporting. However, this is a restrictive and expensive means for collecting data about OTC market positions and participants. Cargill believes that this can accomplished efficiently by having standardized reporting requirements to the CFTC by the OTC provider community. Other sections of the draft bill directly address the issue of better data and reporting, and will achieve the needs of the Commodity Futures Trading Commission and Congress.

One solution would be to have the CFTC restrict OTC activity to approved OTC providers. These approved OTC providers would have a reporting requirement to the CFTC in a standardized format and on a regular basis of all OTC transactions by customer that exceed a certain size threshold. The CFTC would have the ability to investigate and curtail any OTC customer whose position they believe is too large for the underlying commodity markets. The CFTC has this existing authority for investigating customer positions at the clearing broker on listed futures and it works well.

Another stated benefit of centralized clearing is the mitigation of counterparty credit risk, since it requires both initial margin and the daily settlement or margining of 100% of the mark-to-market differences between the two parties. While centralized clearing has a role and should be encouraged for financially weaker market participants, financially strong food companies, industrials, commercials and producers should have flexibility to negotiate their own credit terms.

As they stand today, the agriculture and energy OTC markets allow for efficient and prudent extension of credit by the OTC provider to financially strong hedging customers. Removing this flexibility for both simple and tailored OTC products will greatly reduce hedging activity due to the working capital requirements of margining. Changes to the current system would be occurring at a time when liquidity and credit are already critically constrained, and at a time when hedging should be encouraged, given the volatility in today's commodity markets.

Agricultural and energy OTC product providers for many years have effectively used margining agreements and other credit support mechanisms to manage credit exposures. OTC product providers, including Cargill, have developed processes and built systems that enable us to value our customers' OTC positions and send position statements daily with updated and transparent product valuations. Based upon these valuations and statements, the parties pay or receive margin collateral daily once a credit threshold is reached. This system works very well. Again, if there was ever a test for this it was during the past year.

Changing this flexibility in setting credit terms will have the perverse effect of reducing the hedging activity across financially stronger customers since they are the ones currently receiving margining credit from the OTC provider community. Financially weaker customers are either not receiving the margining credit from the OTC provider or they are already using futures because it is their only option. It must be recognized that centralized clearing penalizes participants with strong financial positions.

Mandatory Clearing Can Impact Producer Pricing Opportunities

Within the agriculture and energy markets, simple OTC swaps convey many benefits through the flexibility in setting credit terms. In the physical grain business, cash flow mismatches exist for grain buyers since they are required to meet the daily margining requirements of futures hedges and are not able to collect an offsetting margin payment from the farmer since physical grain purchase contracts are typically not margined with the farmer. Last Spring, many U.S. grain buyers, including Cargill, curtailed their deferred purchases of grain from farmers because of the historic run-up in commodity prices and the significant amounts of working capital that were needed for operational inventories and to fund the margin requirements of the underlying futures hedges for deferred contracted grain. This was an extremely difficult time for farmers and for grain buyers.

Critically, it was simple OTC swaps on the grains that helped enable Cargill and other grain buyers to reopen deferred purchases of grain from the farmer during 2008. Using simple OTC swaps, grain buyers were able to move their hedging for contracted bushels from futures to OTC swaps with OTC providers that put in place margin credit thresholds on the mark-to-market exposure. The bill in its current form only grants an exception to centralized clearing for highly customized swaps, but not for simple swaps. Had the bill been in place in its current form, Cargill and other grain buyers would not have been able to use simple swaps to help mitigate the margin requirements imposed on futures hedges. As a consequence, farmers would have been further burdened by a lack of pricing and liquidity for their crops.

Mandatory Clearing Is Extremely Difficult for Customized Products

While the bill currently has provisions that allow for exceptions to centralized clearing for highly customized transactions, it is unclear what will and will not qualify for this exception. It is critical that changes are not made that would in any way inhibit customized hedges, as this would also significantly reduce prudent hedging among market participants.

A key attribute of the OTC markets in agricultural and energy is the broad menu of product choices, as well as specific tailoring of the hedging instrument to precisely meet the hedger's needs. The advantages of product choices and tailoring are that they deliver both a more efficient hedge and a more cost-effective hedge because the hedger is not paying for something that they do not need. It also allows for diversification of products, which is so critical in today's marketplace. OTC product choices include protection size, protection periods, protection levels, and types of protection.

If you think of a futures contract as one type of product, Cargill has over 130 different types of OTC products that we are offering our hedging customers. From these 130 different product types, the hedging customer can choose to further tailor the protection timeframe, price level and transaction size. Given this, no two OTC transactions are identical, which is why centralized clearing is problematic. Clearing organizations do not have the systems and processes necessary to value and clear a wide range of products with a high degree of customization. If this were the case, tailored risk management services would have become available on exchanges years ago.

OTC providers such as Cargill create new products by having strong customer relationships, listening to and understanding our customers' commodity risks, and developing products to address these risks. This requires a significant investment of time, human and technological resources, and financial capital. Centralized clearing will put intellectual property in the public domain immediately which will eliminate any economic incentive that OTC providers have for new product development. Now more than ever, customers need new and better products to help them hedge.

Summary

Cargill appreciates the work of the House Agriculture Committee in ensuring that both the exchange-traded and OTC market perform well. These markets provide critical functions in allowing open price discovery and enhance risk management opportunities. Well performing markets benefit all participants across the supply chain.

This past year was clearly a volatile and difficult time for the commodity markets. Steps can and should be taken to improve market transparency and reporting, as well as ensuring that position limits are effectively enforced.

We have serious concerns about sections 6 and 13 in the draft legislation, but we are confident that we can constructively work together with Members of this Committee to develop policy alternatives that will help ensure the integrity of the markets, while minimizing the unintended consequences.

Thank you for the opportunity to testify before the Committee today and we look forward to working together as the legislation continues to develop.

The CHAIRMAN. Thank you very much, Mr. Hale, for your testimony.

Mr. Cooper, welcome to the Committee.

STATEMENT OF KARL D. COOPER, CHIEF REGULATORY OFFICER, NYSE LIFFE, LLC, NEW YORK, NY; ON BEHALF OF NYSE EURONEXT

Mr. COOPER. Chairman Peterson, Ranking Member Lucas, and Members of the Committee, I am Karl Cooper. I am the Chief Regulatory Officer of NYSE Liffe. NYSE Liffe is the new futures exchange launched by NYSE Euronext just this past September. All in all now, NYSE Euronext operates seven cash equity exchanges and seven derivatives exchanges in five different countries around the world.

It is a pleasure to appear before you today to share NYSE Euronext's views and thoughts on the "Derivatives Markets Transparency and Accountability Act." We strongly support the two major purposes of the proposed legislation: to support the integrity of U.S. contract markets and to promote the transparency of the over-the-counter derivatives market.

We do have to share with you, though, our reservations that many provisions of the bill may not be the most effective means to achieve your ends. That is because the bill tends to run counter to the international cooperative approach that the CFTC has championed over the past many years, and has led to some great successes. Namely, it has allowed U.S. market participants to have access to foreign markets, and it has also allowed U.S. exchanges to compete globally.

I would like to focus my remarks, though, on three specific provisions of the bill: first, section 3, which deals with the direct regulation of foreign exchanges; section 13 of the bill, which mandates centralized clearing; and finally, section 16.

With regard to foreign exchanges, we are concerned that, without evidence that the CFTC has been unable to obtain through cooperative means critical trade information, that the mere mandate of that by the Congress could have regulatory retaliatory consequences by foreign regulators. That would not serve Congress's purpose. It would not serve U.S.-based exchanges that are trying to compete, such as ourselves, globally. And it would hinder our ability to bring new exchange-traded and centrally cleared solutions that are desperately needed now in light of the current market turmoil.

With regard to section 13, we have a similar concern around the international impact, potentially, of the legislation. But let me first say that, obviously, we support the centralized clearing of OTC derivatives. We have established and launched the first CDS clearing solution this past December 22nd in our London exchange, Liffe, with our partner, LCH.Clearnet. But the legislation, as drafted, would not allow foreign MCOs that are regulated by an acceptable foreign regulator to play that clearing function, at least for commodities outside of excluded commodities.

Second, we would suggest that the exemptive provision in section 13 should be broader to give the CFTC the ability to work through the complex issues of bringing the OTC derivative products into a centralized clearing format, with the flexibility around the types of products that should go into the clearinghouse.

With regard to section 16, which limits allowable CDS to only those transactions where the participant has the underlying risk, we think that this restrictions goes too far. Of course the CDS marketplace needs additional enhanced regulation. There must be controls for systemic risk. There must be monitoring for fraud, abusive and manipulative activity. But simply banning all but the limited types of transactions that the bill currently would allow would eliminate market making, would eliminate index trading, and would basically eliminate speculation.

The Commodity Exchange Act has always allowed for speculation, but it has not allowed excessive speculation. So, that is where the balance could best be struck. And, again, without coordinating our efforts with our international regulatory colleagues, we would have the effect of pushing the business offshore, which would not serve U.S. citizens and the U.S. economy in the long run.

Thank you very much for inviting me to appear before you today. And I would be happy to answer any questions you might have.

[The prepared statement of Mr. Cooper follows:]

PREPARED STATEMENT OF KARL D. COOPER, CHIEF REGULATORY OFFICER, NYSE LIFFE, LLC, NEW YORK, NY; ON BEHALF OF NYSE EURONEXT

Chairman Peterson, Ranking Member Lucas, Members of the Committee. My name is Karl Cooper, and I am the Chief Regulatory Officer of NYSE Liffe, LLC ("NYSE Liffe"), a subsidiary of NYSE Euronext. NYSE Liffe is a relatively new exchange, having been designated by the Commodity Futures Trading Commission ("Commission") as a contract market in August 2008. I am pleased to appear this morning on behalf of NYSE Euronext and its affiliated exchanges as the Committee considers the Derivatives Markets Transparency and Accountability Act of 2009.

NYSE Euronext operates the world's largest and most liquid exchange group. NYSE Euronext brings together seven cash equities exchanges in five countries and seven derivatives exchanges. In the United States, we operate the New York Stock Exchange, NYSE Arca, NYSE Alternext (formerly the American Stock Exchange), and NYSE Liffe. In Europe, we operate five European-based exchanges that comprise Euronext—the Paris, Amsterdam, Brussels and Lisbon stock exchanges, as well as the Liffe derivatives markets in London, Paris, Amsterdam, Brussels and Lisbon. We also provide technology to more than a dozen cash and derivatives exchanges throughout the world. NYSE Euronext's geographic and product diversity has helped to inform our analysis of the bill you are considering today.

NYSE Euronext supports the essential purposes of the Committee draft legislation: (i) enhancing the integrity of U.S. contract markets; and (ii) bringing transparency and risk reduction to the over the counter ("OTC") derivatives markets. Nonetheless, we are concerned that the breadth of the bill may have unintended consequences. Our comments today focus on those provisions of the bill that we believe could inhibit the ability of U.S. exchanges to compete globally and deny U.S. market participants access to critical risk management products.

The Commission, with the encouragement and active support of Congress and market participants, has long played an active role in developing standards of regulatory best practices and strengthening customer and market protection through international cooperation including, in particular, information sharing among regulatory authorities. The Commission has been an active participant in the meeting of the International Organization of Securities Commissions ("IOSCO") and, more recently, has joined with the Committee of European Securities Regulators ("CESR") to consider ways to facilitate the conduct and supervision of international business. In addition, the Commission is party to a number of bilateral and multilateral memoranda of understanding, each of which is designed to assure timely access to critical market information.

Similarly, the regulatory relief that the Commission has provided to foreign exchanges that seek to do business with U.S. market participants is predicated on a Commission finding that the exchange is subject to a comprehensive regulatory program that is comparable, though not identical, to the Commission's own regulatory program. As important, such relief is subject to extensive terms and conditions. In particular: (i) satisfactory information sharing arrangements must be in place among the Commission, the foreign exchange, and the foreign exchange's regulatory authority; and (ii) the foreign exchange and each member of the exchange that conducts business under the relief must consent to the Commission's jurisdiction. In all cases, the Commission retains authority to modify, suspend, terminate or otherwise restrict the terms of any relief that it may provide.

By any measure, we believe the Commission's approach to international regulation has been a success, assuring the protection of customers and the integrity of the exchange-traded markets, while facilitating the development of global derivatives markets. A critical key to this success has been the Commission's willingness to cooperate with those regulatory authorities in foreign jurisdictions that share a common regulatory philosophy. A different regulatory approach, one that imposed our regulatory structure on any foreign exchange or intermediary that sought to do business with U.S. market participants, might well have led to regulatory retaliation, causing the global competitiveness of U.S. exchanges to suffer.

As the Committee continues its consideration of the Derivatives Markets Transparency and Accountability Act of 2009, we ask the Committee to ensure that this legislation will in no way weaken the spirit of international cooperation that has played such an important role in the growth of the regulated derivatives markets, and which the Commission has so successfully fostered.

Section 3. Transparency of Off-Shore Trading. It is the fear of regulatory retaliation that underlies our concern with the provisions of section 3 of the Committee draft legislation. We appreciate the Committee's desire that the Commission have access to critical trade information relating to contracts listed for trading on foreign exchanges that settle to a contract listed for trading on a U.S. contract market. We also recognize that this section is narrowly written to target a specific perceived problem. Nonetheless, as written, section 3 appears to subject the foreign exchange to the direct supervision of the Commission.

As discussed above, the Commission has full authority through its information sharing arrangements with a foreign exchange authorized to permit direct access and its home country regulator to obtain the type of information described. Further, the Commission can rescind this authorization at any time, if the requested information is not provided. In the absence of evidence that the Commission has been unable to obtain required trade information through cooperative means, we believe section 3 sets an unnecessarily confrontational tone and risks setting off a chain reaction of retaliatory measures.

Section 13. Clearing of OTC Derivatives. For many of the same reasons, we are troubled by the provisions of section 13, which would require that, except for OTC derivatives instruments on "excluded commodities," all OTC derivatives must be cleared through a derivatives clearing organization registered with the Commission. To be clear, NYSE Euronext strongly supports legislative action that would encourage and facilitate the clearing of OTC derivatives instruments.

In this regard, we note that, on December 22, our London derivatives exchange, Liffe, acting in cooperation with LCH.Clearnet Ltd., launched the first clearing solution for the processing and clearing of credit default swaps ("CDSs") based on certain credit default indexes. Shortly thereafter, we received necessary exemptions from the Securities and Exchange Commission to offer CDS clearing to qualified U.S. customers. (Both Liffe and LCH.Clearnet are supervised by the U.K. Financial Services Authority.)

Nonetheless, we believe section 13 goes too far in seeking to force a clearing solution for OTC derivatives instruments limited to DCOs. We are especially concerned that this section apparently would no longer permit a multilateral clearing organization supervised by a foreign financial regulator that the Commission determines "satisfies appropriate standards" to clear OTC derivatives instruments, as is currently provided under section 409 of the FDIC Improvements Act of 1991.

Liffe expects to receive authorization shortly from the Financial Services Authority to act as a self-clearing recognized investment exchange. Among other services, Liffe anticipates acting as a central clearing counterparty for OTC derivatives instruments. Under the provisions of section 13, however, Liffe could not offer these services to U.S. persons (except with respect to excluded commodities), unless it first applied for registration with the Commission as a DCO. Such registration would subject Liffe to duplicative and, in some instances, potentially conflicting regulatory requirements.

The OTC derivatives market is a global market, which demands a global response. An American solution to clearing OTC derivatives instruments is no less palatable than a European solution. Yet, this legislation would lend support to those in Europe who are urging such action.

Separately, we believe the standards pursuant to which the Commission would be able to grant an exemption from clearing are too narrow. Fully implementing a clearing solution for OTC derivatives will be very difficult. The Commission should have broader authority to grant exemptions where appropriate.

Section 16. Credit Default Swaps. With all of the negative publicity that credit default swaps have received over the past several months, we appreciate the Committee's concern and its desire to restrict in some way the volume of trading in these instruments. But the fact remains that credit default swaps are a vitally important tool in managing risk. In difficult economic times, the diversification of risk, if used properly, will continue to add value to the marketplace.

We believe section 16 goes too far in seeking to reduce any perceived financial risk in the trading of CDS. Its provisions would effectively close the market in the U.S., driving the business overseas. This is because it is impossible to conceive of a situation in which both parties to a CDS would experience a financial loss if an event to a credit default swap occurs. By definition, one party must benefit from such a trade. The market for CDS, no less so than the market for exchange-traded futures, needs speculators if it is to maintain sufficient depth. Without the liquidity that speculators bring to the market, price spreads would widen, severely reducing, if not eliminating, its value.

Moreover, we are concerned that the provisions of section 16 would prohibit swaps on credit default indexes. We believe it is unlikely that institutional participants that use these indexes to hedge their securities portfolios hold all of the securities that comprise the index. Nonetheless, these swaps are more liquid and are easier to trade than CDSs on a single name security. Although not perfect, they provide a sufficient hedge at a lower cost than a series of CDSs on single names.

Conclusion. Thank you, again, for the opportunity to appear before the Committee today. I would be happy to respond to any questions you may have.

The CHAIRMAN. Thank you very much, Mr. Cooper.

Mr. Cicio, welcome to the Committee.

STATEMENT OF PAUL N. CICIO, PRESIDENT, INDUSTRIAL ENERGY CONSUMERS OF AMERICA, WASHINGTON, D.C.

Mr. CICIO. Good afternoon, Mr. Chairman, Ranking Member Lucas, and Members of the Committee. My name is Paul Cicio. I am the President of the Industrial Energy Consumers of America, thank you for the opportunity to testify here.

IECA member companies are exclusively from the manufacturing sector and unique, in that our competitiveness is dependent upon the cost of energy.

Mr. Chairman, we are very grateful for the attention this Committee is giving to this incredibly important issue. And this legislation is an excellent start to addressing excessive speculation in commodity markets. Specifically, excessive speculation in the first half of 2008 cost consumers $40.4 billion, and that is just for natural gas.

IECA supports most of the draft as it is currently written, so, with your permission, I will just address those areas where we have some recommendations or concerns.

Point number one: section 6 creates an energy and agriculture position limit advisory group. It is essential that the advisory group be numerically weighted in favor of physical producers and consumers who are *bona fide* hedgers, and that its governance favor the consumer to ensure the best interests of those who are paying the bill, the consumer.

Point number two: We strongly encourage the legislation to require aggregate position limits. Your draft bill proposes Federal speculation limits on the regulated markets and eliminates the swap loophole by limiting hedging exemptions to *bona fide* hedgers who would have physical risk. However, Mr. Chairman, the draft bill only calls for studying speculative position limits on the over-the-counter market.

In order to prevent speculators from moving between markets to evade speculation limits, speculative position limits need to be aggregated to cover designated contract markets, the exempt commercial markets, foreign boards of trade, and over-the-counter markets.

Over-the-counter trading is not insulated from the cash markets. It impacts cash prices in two ways: first, through arbitrage between the OTC swap market and the cash market; and, second, through arbitrage between the swaps market and the futures market. Futures prices, in turn, are used as the reference price for most cash transactions. Swap dealers can also shift their risk to other trading platforms, such as the IntercontinentalExchange, and foreign boards of trade, such as ICE Futures.

Mr. Chairman, unless there is an umbrella which covers all of these venues, particularly with respect to commodities for U.S. delivery such as natural gas, speculators will circumvent the regulated venues in favor of unregulated venues. For that reason, we urge to you require the CFTC to provide aggregate position limits across all exchanges in order to control excessive speculation in energy commodities.

Point number three: section 13 requires clearing of all over-the-counter transactions. We do not support requiring *bona fide* commercial hedgers, such as ourselves, to clear. The problem of excessive market speculation is not caused by commercial hedgers, and our volumes are too small to manipulate the market. For example, in natural gas, our volumes are well under five percent of the market. Requiring us to clear our transactions will significantly increase transaction costs to the extent that it could become a disincentive for industrial consumers to manage risk. Clearing transactions would require us to post significant sums of margin capital, which is very difficult to do even under good economic times.

Point number four: Consumers need assurances that this legislation deals appropriately with index funds and other passive, long-only, short-only investment instruments that have a significant negative impact on the market, and will do so again unless these instruments are limited in volume or banned. The draft legislation only requires reporting, which is not sufficient.

Number five, and our final comment: Regarding treatment of carbon allowances and offsets, we have deep concerns about including this provision. U.S. manufacturing companies who have been studying cap and trade and our colleagues in Europe believe that carbon trading could very well be the next subprime crisis. Our written testimony includes an article from *The Guardian,* a U.K. newspaper, dated January 30, 2009, entitled "Carbon Trading: The Next Sub-prime."

Trading and offsets are very susceptible to fraud and manipulation. Cap and trade is only one of several policy approaches to regulating carbon, and the alternatives would not require carbon trading and creation of other high-risk derivative trading markets. Including carbon emissions as a tradeable commodity is premature to Federal policy decision making, and Congress should not limit the debate to trading.

Thank you.

[The prepared statement of Mr. Cicio follows:]

PREPARED STATEMENT OF PAUL N. CICIO, PRESIDENT, INDUSTRIAL ENERGY CONSUMERS OF AMERICA, WASHINGTON, D.C.

Mr. Chairman, Ranking Member Lucas, and Members of the Committee, my name is Paul N. Cicio. I am President of the Industrial Energy Consumers of America (IECA). Thank you for the opportunity to testify before you on the draft legislation entitled "Derivatives Markets Transparency and Accountability Act of 2009".

IECA is a 501(c)(6) national nonprofit non-partisan cross-industry trade association whose membership is exclusively from the manufacturing sector. IECA promotes the interests of manufacturing companies for which the availability, use and cost of energy, power or feedstock play a significant role in their ability to compete in domestic and world markets. IECA membership represents a diverse set of industries including: fertilizer, steel, plastics, cement, paper, food processing, aluminum, chemicals, brick, rubber, insulation, glass, industrial gases, pharmaceutical, construction products, foundry resins, automotive products, and brewing.

For those on Wall Street who still do not acknowledge that excessive speculation is a problem, let me briefly describe what happened to natural gas prices in the time period of January to August of 2008.

During the first half of 2008, excessive speculation drove the NYMEX price of natural gas from $7.17/mm Btu in January to a high of $13.60/mm Btu in July before prices began to recede. During that same time period, the Energy Information Administration reports that domestic production increased by 8.6 percent; demand was essentially unchanged from the previous year and that national inventories were in the normal 5 year average range for that time of the year. These facts prove that the price spike was not driven by supply *versus* demand fundamentals. Unfortunately for homeowners, farmers and manufacturers, the net increase in the price of natural gas cost consumers over $40.4 billion from January to August 2008 when compared to the same time period in 2007.

It is also important to highlight to the Committee that natural gas was specifically targeted by traders for manipulation more than any other commodity during that same time period by a significant margin. This information comes from the Commodity Futures Trading Commission (CFTC) September, 2008 report entitled "Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations." The report highlights that more noncommercial traders exceeded the speculative limit or exchange accountability levels for trading natural gas than any other commodity and by a very high margin.

The below paragraph is from the report.

> *Exceeding Position Limits or Accountability Levels:*
>
> *On June 30, 2008, of the 550 clients identified in the more than 30 markets analyzed, the survey data shows 18 noncommercial traders in 13 markets who appeared to have an aggregate position (all on-exchange futures positions plus all OTC equivalent futures combined) that would have been above a speculative limit or an exchange accountability level if all the positions were on-exchange. These 18 noncommercial traders were responsible for 35 instances that would have exceeded either a speculative limit or an exchange accountability level through their aggregate on-exchange and OTC trading that day. Of these instances: eight were above the NYMEX accountability levels in the natural gas market; six were above the NYMEX accountability levels in the crude oil market; six were above the speculative limit on the CBOT wheat market; three were above the speculative limit on the CBOT soybean market; and 12 were in the remaining nine markets.*

Mr. Chairman, we are very grateful for the attention this Committee is giving this incredibly important issue and this legislation is an excellent start to addressing excessive speculation in commodity markets.

IECA strongly supports: section 3 that establishes speculative limits and transparency of offshore trading; section 4 that requires increased transparency through detailed reporting and disaggregation of market data that includes index funds and other passive, long-only and short-only investors in all regulated markets and data on speculative positions; section 5 that increases transparency and record-keeping to the CFTC and includes over-the-counter (OTC) contracts; section 6 that establishes trading limits to prevent excessive speculation and creates a Energy and Agriculture Position Limit Advisory Group that would provide recommendations on setting position limits; section 7 that provides for at least 200 additional full-time CFTC employees; section 8 that ensures that prior CFTC actions are consistent with this Act.

IECA areas of concern and recommended improvements are as follows:

More Transparency in CFTC Processes

We encourage the legislation to reflect a change in culture at CFTC to one that has more transparency and public input into their decision making processes. We prefer the Federal Energy Regulatory Commission (FERC) model. The FERC frequently have rule making processes that allow for public comment and organize sessions that are similar to your Congressional hearings in which entities are solicited for comment. At FERC, there are ample opportunities for written public input as well.

Section 13: Clearing of Over-the-Counter Transactions

We do not support requiring commercial hedgers such as ourselves to be required to clear their transactions. The problem of market speculation is not caused by commercial hedgers and they are a relatively small portion of the market. The problem is non-hedgers or speculators. For this reason, only speculator bilateral OTC transactions should be cleared. We believe that requiring commercial hedgers to clear their transactions will potentially decrease our competitiveness through increased complexity and cost creating a disincentive for industrial users to manage risk.

We also urge the Chairman to add provisions to section 13 that will increase transparency to the CFTC decision making process and with a public comment period.

Section 6: Trading Limits to Prevent Excessive Speculation—Establishment of Advisory Groups

We strongly support the establishment of a Position Limit Advisory Group for both agricultural and energy commodities. However, we recommend an additional step in the process by requiring that a public comment period be added to further increase transparency of the process. We further recommend that the governance of this advisory group favor the consumer perspective to ensure the best interest of those paying the bills.

Section 14: Treatment of Emission Allowances and Offset Credits

We have concerns including this provision. Including carbon emissions as a tradable commodity in this legislation is premature to Federal policy making. The Congress has not decided how it will regulate greenhouse gas emissions and we are concerned that this legislation would preempt that decision.

U.S. manufacturing companies that have been studying cap and trade and our colleagues in Europe believe that carbon trading will be the next Sub-Prime Crisis. Attached is a copy of a recent article from *The Guardian*, a UK newspaper dated January 30, 2009 entitled "Carbon Trading: The Next Sub-Prime." We encourage the Committee to read it. (*Attachment A*)

Carbon cap and trade is only one of several policy approaches to regulating carbon and alternatives would not require trading carbon. Other alternatives include a carbon tax, sector approaches (example: CAFE); energy efficiency or GHG intensity mandates for the manufacturing sector or setting energy efficiency standards on every major energy consuming device thereby reducing energy consumption (example: appliance standards) and building codes for homes and commercial buildings.

In general, manufacturers have raised serious concerns regarding cap and trade because it is not transparent; offsets are easily subject to manipulation; it cannot be effectively border adjusted which means importers who are not burdened with equivalent higher costs will take business away from domestic producers and will result in lost jobs; it raises energy costs that manufacturers cannot pass-on because of international competition.

The Industrial Energy Consumers of America welcomes the opportunity to work with the Committee on Agriculture as it moves forward with this legislation.

PAUL N. CICIO,

Paul N Cicio

President,
February 4, 2009.

ATTACHMENT A

Carbon Trading: The Next Sub-Prime

January 30, 2009

The Guardian, Friday 30 January 2009
By TERRY MACALISTER

Climate and Capitalism has long argued that carbon trading is a scam to boost profits without reducing emissions. Here's confirmation from an unexpected source: the CEO of a major European energy company.

The row over the working of the European Union's emissions trading scheme intensified last night when EDF Energy warned that speculators risked turning carbon into a new category of sub-prime investment.

Vincent de Rivaz, the chief executive of the UK arm of the French-owned gas and electricity group, said politicians and regulators needed to revisit the way the ETS was working and whether it was bringing the results they wanted. "We like certainty about a carbon price," he said. "[But] the carbon price has to become simple and not become a new type of sub-prime tool which will be diverted from what is its initial purpose: to encourage real investment in real low-carbon technology."

Green campaigners have long been critical of the way the emissions trading scheme was set up, but it is unusual for a leading industry figure to cast doubt on it, as power companies lobbied hard for a market mechanism to deal with global warming.

"We are at the tipping point where we . . . should wonder if we have in place the right balance between government policy, regulator responsibility and the market mechanism which will deliver the carbon price," said de Rivaz.

De Rivaz's comments came as Tony Hayward, chief executive of BP, emphasised that a predictable global carbon price was important because it would make "vast numbers of alternative energy sources competitive". He told the World Economic Forum in Davos that certainty over carbon emissions would help "solve the world's energy problems".

Their comments came days after the Guardian revealed that steelmakers and hedge funds were cashing in ETS carbon credits obtained for free, causing the price of carbon to plunge. The price of carbon has slumped from €30 a tonne to below €12, leading to a tail-off in clean-technology offset projects in the developing world.

The EU's emissions trading scheme was set up as a market solution to cut greenhouse gas pollution from industry. Polluters were issued with permits that can be traded between companies and countries as a way of encouraging an overall reduction in carbon output. However, companies are now cashing them in. Up to €1bn-worth of permits are said to have been sold off in recent months as companies see an opportunity to bring in funds at a time when their carbon output is expected to fall due to lower production.

De Rivaz said an over-reliance on markets without tougher safeguards was responsible for the financial turmoil that has sent banks into administration or forced sale. He believed there had been a "lost sense of values" and he was anxious that this should not extend into the energy sector, but was not prepared yet to call for a carbon tax to replace the ETS.

Point Carbon, an information provider and consultancy, claims the sell-offs are only one of a number of factors influencing carbon prices and argues it is "rational" for them to be selling off credits.

"Recession in Europe is bringing a slowdown in manufacturing, meaning less production and less emissions," said Henrik Hasselknippe, global head of carbon at Point Carbon. "Companies are doing exactly the rational thing in these circumstances, which is to sell if they are long on credits. If they are emitting less then they do not need the credits so much and the price of carbon will fall."

However, Bryony Worthington, an expert on climate change and founder of *sandbag.org.uk*, said: "What should have been a way to kick-start investment in much needed low-carbon, efficient technologies is now a cash redistribution exercise."

A study commissioned by the WWF environmental organisation from Point Carbon, published in March last year, estimated that "windfall profits" of between €23bn and €71bn (£20.9bn–£64.4bn) would be made under the ETS between 2008 and 2012, on the basis that the price of carbon would be between €21 and €32. Up to €15bn could be made by British companies that were given credits they did not need.

The CHAIRMAN. Thank you, Mr. Cicio.

Mr. Brickell, welcome to the Committee.

STATEMENT OF MARK C. BRICKELL, CEO, BLACKBIRD HOLDINGS, INC., NEW YORK, NY

Mr. BRICKELL. Thank you, Mr. Chairman. Thank you, Members of the Committee, for inviting Blackbird Holdings to testify at this hearing about the "Derivatives Markets Transparency and Accountability Act of 2009."

We are grateful that the Committee and the Congress want to address the causes of the financial crisis. Americans are concerned. Banks have been shaken. The stock market has tumbled. Pension investments and home values have shriveled. The wolf is at the door. What can Congress do to help? The first step would be to identify the true causes of the financial crisis.

Our global financial crunch is a housing finance crisis. Trillions of dollars of mortgage loans have been made that are not being repaid on time. Those loans are worth less than face value, and so are the mortgage-backed securities that contain them. Stockholders, bond holders, taxpayers will absorb as much as $1 trillion of losses from loans that should not have been made.

But this bill doesn't target foolish mortgage loans. It targets derivatives. If our country has a wolf problem, it probably won't help to go into the field to shoot birds.

Mr. Chairman, these privately negotiated derivatives, these swap contracts, have helped the financial system and the economy. Every company faces risks when it opens its doors to do business, and swaps help those companies shed the risks they don't want and assume the risks that they do.

Each company's portfolio of risks is unique. Each firm's appetite and ability to manage risk is unique. And swaps meet those individual needs because they can be custom-tailored. Banks structure them to meet a client's market risks, right down to the dollar and to the day, if necessary.

And we don't just structure them to meet market risks. Swappers custom-tailor the credit risk of the contracts, too. Each counterparty in a swap contract is on the hook to the other. So each one has a good reason to assess the other's credit quality, and do it with care. If one doesn't like what he sees, he asks the other to shrink the deal, or shorten the maturity, or post collateral, or raise more capital.

We use innovative technology to promote transparency, integrity, and control of credit risk, the goals of your bill. And our company has built an electronic trading platform for swaps. Not only does it allow users to find counterparties for their swaps online, our patented credit filter prevents one firm from trading with another when credit lines are full.

Credit risk is managed more precisely than it is with a central clearinghouse to the individual specifications of each user of the system. Companies need custom-tailoring, and that is why swaps were invented. It is also why there are nearly $700 trillion, a notional amount, that are managing risks today for companies and governments around the globe.

And Congress knows this. You all have passed the laws that make the framework in which standardized futures contracts are traded on futures exchanges, regulated by the CFTC, and cleared through CFTC-regulated clearinghouses. While swaps that have many of the same risks as bank loans are defined in Federal law as banking products, banking supervisors have access to the details of every swap on a bank's books.

How good is this framework? Not only has it been good for the economy, it has also been good for the futures exchanges. The custom-tailored risks that banks collect from their clients they often manage with futures contracts. So futures trading has grown along with swap activity.

No country has built a more diverse, robust risk management industry. Now, it is not perfect. No financial transaction or system of risk management can prevent all investment losses. Good judgment remains the essential element in sound financial management. But it is good. Swaps make it easier and less expensive to create the risk management profile that a company prefers.

I am concerned about the proposed legislation because it will do damage to all of this. It is not just that derivatives are the wrong target. This legislation is like shooting doves with an 8-gauge: If you connect, there won't be anything left. And American firms, in the middle of a credit crunch, would face new obstacles as they try to manage credit risk. Important tools for managing not just credit risk but interest rate risk, as well, would be more costly and less available. So American firms would have to watch from the sidelines as their competitors in other countries manage their risks with greater precision, and more freely than American companies would be able to do.

So if this bill passes, we will not have much of a swaps activity left in the United States, and we would not be better off. Suppose that Congress passed a law that outlawed swaps completely? Would the financial crisis be gone? No. Those trillions of dollars of troubled mortgage loans would still be there. They would just be harder to manage.

Privately negotiated derivatives with bilateral infrastructure, sound documentation, netting provisions to support them, have been called no less than the creation of global law by contractual consensus. It is a system that has benefited thousands of companies, financial institutions, and sovereigns. It is a system that has an important part to play as we work to solve the problems of economic weakness and financial market uncertainty. Great care should be taken to optimize and not to weaken this innovative and important business.

Thank you.

[The prepared statement of Mr. Brickell follows:]

PREPARED STATEMENT OF MARK C. BRICKELL, CEO, BLACKBIRD HOLDINGS, INC., NEW YORK, NY

Mr. Chairman and Members of the Committee:

Thank you very much for inviting Blackbird Holdings, Inc. to testify at this hearing about the "Derivatives Markets Transparency and Accountability Act of 2009". We are grateful to the Committee for asking for our views as it seeks a wide perspective on the benefit and drawbacks of legislation affecting privately negotiated derivatives. For more than 2 decades, swaps and related derivatives contracts have made an important contribution to improvements in risk management at banks, in the financial sector, and in the economy. The benefits of these transactions are sufficiently important that any measures adopted by the Committee or the Congress should not reduce the availability or increase the cost of these valuable tools.

About Blackbird

Blackbird Holdings, Inc. is a privately held corporation headquartered in Charlotte, North Carolina. It was founded by swap traders from J.P.Morgan & Co. who developed an electronic trading platform for the negotiation of interest rate and currency swaps. Our innovative technology has been patented three times by the U.S. Government. The benefits of electronic trading have already been achieved in the execution of most types of financial transactions, including foreign currency, equities, U.S. Treasury bonds and corporate bonds, and futures contracts. When swap contracts are executed electronically in greater numbers, swaps will have greater transparency, and accurate electronic records will be created at the moment the trade is executed so that error-free straight through processing, including accurate record-keeping, will be a hallmark of the business. Blackbird is still a small company, but we are global, and we help swap counterparties find each other and execute swaps either across our electronic platform, or through our people in Singapore, Tokyo, London, and New York.

I have served as Chief Executive Officer of Blackbird since 2001. Before that, I served for 25 years at JP Morgan & Co., Inc., where I was a Managing Director and worked in the derivatives business for 15 years. During that time, I served for 4 years as Chairman of the International Swaps and Derivatives Association, and for 2 years as Vice Chairman, during more than a decade that I served on its board of directors. ISDA represents participants in the privately negotiated derivatives business, and is now the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 850 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 swaps and related contracts to manage efficiently the financial market risks inherent in their core economic activities. As a result, I was involved in discussions about all Federal swaps legislation between 1988 and 2000.

Why Swaps?

The moment that companies open their doors to do business, they become exposed to financial and other risks that they must manage. Changes in foreign currency rates can affect the volume of their exports; interest rate volatility the level of investment returns, and commodity price fluctuations the cost of raw materials—or sales revenue. Managing these risks was an essential part of decision-making in business and finance before swaps were developed, and would remain so if swaps did not exist.

Custom-tailored swap transactions were developed to make it easier to manage these risks. They allow a party to shed a risk that he does not want to take, in return for assuming another risk to which he would rather be exposed, or for making a cash payment. By tearing apart and isolating the strands of risk that are entwined in traditional business and financial transactions, they make it possible to manage risks with greater precision, and allow businesses to focus on the things they do best. A company that sells hamburgers around the globe can use swaps to shift its exposures to interest rates and foreign currencies to other parties, and concentrate on managing its operations, raw materials costs, and real estate holdings, if it believes that these are the source of its comparative advantage. Similarly, the counterparties to its swap trades believe that they are better able to manage the interest rate and currency risks being shed by the other enterprise.

Benefits of Swap Activity

As thousands of swap counterparties make individual decisions about which risks to take and which to transfer to others, several useful things happen. First, the risk profiles of the firms improve every time they make a correct decision. This strengthens them, and makes it possible for them to serve their customers better and grow more rapidly. A bank that has a strong relationship with a borrower might find that the size of its loans to that customer was becoming so great that its loan portfolio was becoming poorly diversified. By entering into credit default swaps, the banker can transfer enough of the loan risk to make room for more loans to its customer, strengthening its business relationship and helping credit to flow. That's good for business, jobs, and the economy.

Second, as thousands of swap transactions have been executed in the past 3 decades, bankers and finance professionals have gained access to new information about financial risks. This allowed better measurement and management of risks, first in swap portfolios and, as time passed, in the other financial portfolios. I watched that process take place in the 1980s as the risk management techniques developed on the swap desks of ISDA member banks, including my own, were adopted by the managers of the same risks that had long been embedded in other financial portfolios at their institutions, including the portfolios of loans and deposits. This process was so constructive that swap professionals were asked in 1993 by the Group of Thirty, to write down their best principles and practices for managing financial risks. The report that we produced was disseminated through the global banking system and other parts of the financial world, and was also used by banking supervisors and financial system regulators to improve their supervisory practices. As Paul Volcker, the Chairman of the Group of Thirty wrote in the introduction to our report, ". . . there can be no doubt that each organization's conscious and disciplined attention to understanding, measuring, and controlling risk along the lines suggested should help ensure that the risks to individual institutions and to markets as a whole are limited and manageable."

As swap transactions are executed, the prices of these deals reveal the beliefs of thousands of individuals about the future course of interest rates, or the creditworthiness of borrowers, which are collected and distilled in the price of the deals. This information can be used even by parties who do not enter into the transactions. Central bankers now use swaps prices to understand interest rate expectations and help them make decisions about monetary policies. Rating agencies have begun to track the information about the credit quality of borrowers that is contained in the price of credit default swaps to identify changes in market opinion, and alert their analysts to changes in the condition of companies that they rate, so that they can drill down on potential problems and strengthen the quality of their ratings. If credit default swaps had existed a decade earlier, to sound a tocsin of warning, current problems in the financial system might not be so grave.

Of course, no type of financial transaction or system of risk management can prevent all investment losses. The good judgment of financial professionals remains the essential element in sound financial management. Swaps simply make it easier and less expensive to create the risk management profile that a company prefers.

You might expect a business that does so much good for so many people to grow quickly, and the swaps business has. While I have been a participant in the swaps business, I have seen it grow by roughly 25% *per annum* for more than 20 years. As a result, there are now according to the BIS almost $684 trillion of swaps outstanding, mainly on interest rates and currencies As of January 27, there were some $28 trillion of credit default swaps outstanding. It is worth noting that, even when other financial activities become illiquid, the swap business tends to be resilient. Credit default swaps dealers, for example, indicate that there has been liquidity in swaps even when traditional cash markets have become illiquid at times in the past year.

Public Policy for Swaps in the United States

These are important benefits. They exist in part because Congress has legislated carefully and wisely with respect to swaps on at least five earlier occasions since 1988. We all want to preserve benefits like these, and I am grateful to you for identifying in legislation now before the Committee several policy ideas that have been floated in recent months, and for your careful consideration of those ideas at this hearing. With careful action, this Committee can continue to play an essential role in building a sound framework for swap activity.

The policy consensus about swaps that is embodied in the statutory and regulatory framework reflects the fact that swap activity arose not in the exchange traded, centrally cleared business of standardized futures contracts regulated by the Commodity Futures Trading Commission, but in the banking sector. Swap contracts are custom-tailored transactions that are often designed to match the exact cash flows that a corporation wants to hedge; this makes them harder to construct, to value, and to transfer, than the futures contracts regulated by the CFTC, in much the same way that a bank loan is different from a corporate bond. This is why the first policy adopted by the CFTC with respect to swaps, in its May 1989 Swaps Policy Statement, after more than 18 months of study, was that swaps are not appropriately regulated as futures. That original CFTC Policy reflects a policy consensus that has lasted 2 decades, reaffirmed and strengthened by the 1991 CFTC Statutory Interpretation, the 1992 Futures Trading Practices Act, and the Commodity Futures Modernization Act enacted in 2000 and signed into law by President Clinton, as well as other legislation. That is why swaps are defined in Federal law as banking products.

A robust, innovative American financial services business has been built on the foundation of this policy consensus. I am concerned that provisions in the legislation before the Committee would undermine that foundation and weaken a business that helps the American economy, and the world.

Management of Credit Risk in Swaps Transactions

One area of the legislation that would have that effect is the section requiring clearing of privately negotiated derivatives. Like every commercial and financial contract, swaps contain credit risk. One party must be confident that his counterparty will perform according to the terms of the contract.

Financial institutions are able to manage this credit risk in different ways. In the banking system, where swaps originated, credit risk is managed by experts who analyze the quality of each counterparty, including its financial strength, the quality and character of management, even the legal and political risk of the country where it is based. In doing this, bankers and their counterparties often rely on private information available to them in their special role as creditors. The techniques used to manage the credit risk of swaps are usually the same ones used to manage the risk of other privately negotiated credit contracts such as bank loans or bank deposits, and they can include the posting of collateral so that if a counterparty defaults on a trade, the non-defaulting party will be able to enter into a new, replacement transaction at no additional cost. Of course, if a counterparty is not satisfied with the amount or quality of the information he receives, or the credit enhancement techniques available, he is not required to enter into any swap deal.

Financial institutions have developed a number of ways to manage credit risk in privately negotiated derivatives, appropriate to their capital levels and those of their clients.

First, there are different ways to document transactions. The simplest method is to use an exchange of confirmations, one for each transaction. This approach makes no attempt to reduce risks by netting, it simply relies on well drafted confirmations and good credit judgment in the choice of counterparties.

Risks are reduced by netting under bilateral master agreements, either for single products—interest rate swaps against interest rate swaps—or reduced further by including other derivatives under the master. Netting across products—foreign exchange options against credit default swaps, for example—reduces potential exposures even more than single product netting. The ISDA Master Agreement is used around the globe to achieve this purpose.

As you can see, we are starting to build a sort of continuum of approaches, in which increasing the numbers of transactions netted against each other results in greater netting benefits. Multilateral netting of credit risks is another step along the continuum, in which a multilateral clearinghouse substitutes its own credit for that or others, and has a bilateral relationship with each of them. In each bilateral relationship, the credit exposure at any moment in time is the net value of the transactions.

At first, this might sound different from the banking model, because futures exchanges operate multilateral clearinghouses. But the difference is mainly one of scale. Every bank serves as a central counterparty for its inter-bank trading partners and its clients. So, in this sense, every swap dealer bank using netting provisions under the ISDA Master Agreement is a clearinghouse.

Each swap dealer assesses the likelihood that his counterparty will default, and his own ability to withstand such a default. In doing so, he is mindful of his own capital base, and the capital strength of his counterparty. Where capital is not high relative to risk, it is more likely that one or both swap counterparties will demand collateral from the other.

Now we have a more complete picture of credit risk mitigation schemes for derivatives. Each scheme has characteristics appropriate to its participants. On one end of the continuum are banks and insurance companies, with traditionally strong capital cushions. At the other end are margin-reliant entities including futures exchange clearinghouses.

A Clearinghouse for Swaps?

It should be clear at this point that creating a new clearinghouse for swaps, or for one type of swaps like credit default swaps, or forcing swaps into some other clearinghouse, would not exactly make order out of chaos. A good deal of order already exists. It is the order that markets bring to human affairs, giving participants the opportunity to choose, and to change their choices. Today swap participants can choose among several different methods to handle credit risk. We can keep the contracts on our own books, netting them against other contracts, taking collateral to support the risk as appropriate, or we can submit them to a third party clearinghouse. A system like this allows us to make the right judgments for ourselves and our counterparties, as capital positions change and the mix of clients changes. Every bank changes its mix of business along the continuum, every day.

For this reason, section 13 of the bill is troubling. This section requires that all currently exempted and excluded OTC transactions must be cleared through a CFTC regulated clearing entity, or an otherwise regulated clearinghouse which meets the requirements of a CFTC regulated derivatives clearing organization. While the provision authorizes the CFTC to provide exemptions from the clearing requirement, it can only grant the relief under limited circumstances, provided that the transaction is highly customized, infrequently traded, does not serve a significant price discovery function and is entered into by financially sound counterparties.

Driving swap activity into a central clearinghouse would be undesirable for several reasons. First, it would create a central choke point for activity that is, today, distributed across multiple locations. If a single swap dealer has processing problems or other difficulties, they affect only the dealer's clients. If a central clearinghouse were to have problems, they would affect the entire system's derivatives flows.

Second, the same is true of the credit risk of such a central entity. Pulling the credit risk of swaps out of the institutions where they reside today, and forcing them into a central counterparty, risks creating a new, "too-big-to-fail" enterprise that represents a new risk to taxpayers.

Third, a centralized, collateral-reliant scheme would tend to reduce market discipline. Because parties to bilateral netting agreements retain some individual credit exposure, they must assess their counterparties' credit standing, giving them an incentive to control their positions carefully. The resulting widespread awareness of credit risk makes the financial system safer. In contrast, clearinghouse arrangements tend to socialize credit risk. Our financial system today shows the ill effects of a reduction in market discipline, and Federal policies should increase it, not reduce it.

Fourth, one reason for this is that credit discipline encourages financial institutions to strengthen their capital bases.

Finally, building a central clearinghouse may be an expensive proposition, requiring new capital of its own. In contrast, increased use of bilateral cross product netting under ISDA Master Agreements can be accomplished at low cost. The marginal cost of adding another transaction to an ISDA bilateral master agreement is zero. No other technique offers such substantial risk reduction at such a low cost.

Since, as I indicated above, every swap dealer bank serves as a clearinghouse for its swap trading partners and clients, the provision would have the effect of limiting the ability of banks to engage in this segment of the banking business without the approval of the CFTC. I do not know of any reason to unwind the policy consensus for swaps to adopt such a policy. The netting and close out arrangements that are in use among swap counterparties are the result, in part, of careful work by Congress to establish the enforceability of netting agreements under bankruptcy law. These arrangements have been used in the marketplace and tested in the courts and have managed the credit risk of hundreds of thousands of swap transactions. In the last 12 months alone, the failure or default of a major swap dealer, Lehman Brothers, two of the world's largest debt issuers, Fannie Mae and Freddie Mac, and a sovereign country Ecuador, in addition to the more routine failures of other counterparties have been successfully resolved using these arrangements. In every case the well drafted netting and close out provisions of the ISDA Master Agreements have done what they were supposed to do. Simply put, these arrangements work well, and there is no evidence to support a statutory requirement for clearing of all swap agreements through CFTC-approved central counterparties.

Conclusion

The privately negotiated derivatives business—and the bilateral infrastructure, documentation, and netting that support it—have been called "no less than the creation of global law by contractual consensus." It is a system that works. It is a system that has well served the economy and the financial markets in the U.S. and around the world. It is a system that has benefitted thousands of companies, financial institutions and sovereigns. And it is a system that has an important part to play as we work toward a solution to today's economic weakness and financial markets uncertainty. Great care should be taken to optimize—and not weaken—this innovative and important system.

The CHAIRMAN. Thank you.

Is it not true that, by utilizing these derivatives and swaps or whatever, that these firms were allowed or were able to leverage themselves a lot further than they would have been had they not been available?

I mean, it just looks pretty obvious to me that, without them ostensibly laying off these risks with these credit default swaps and so forth, that they wouldn't have been able to leverage themselves as far as they did. I mean, it did have some effect on this.

The underlying problem are the CDOs and all that, I understand that, the mortgages that shouldn't have been made in the first place. But my concern is that this exacerbated the problem.

Mr. BRICKELL. Mr. Chairman, I am very glad that you asked that question. I heard statements made from the prior panel, and I have certainly seen comments in the newspaper that suggest there are people who believe that swaps allow unlimited leverage or unlimited speculation.

The CHAIRMAN. No, I am not saying unlimited, but I am saying it allowed them to leverage themselves further than they would have been able to otherwise.

Mr. BRICKELL. Absolutely not true, and this is why: When you enter into a swap contract, your counterparty is judging whether or not you are able to perform your end of the bargain.

The CHAIRMAN. Like those geniuses at AIG?

Mr. BRICKELL. You mean the people who judged that AIG would perform?

The CHAIRMAN. Well, the guy who set up the AIG situation told the CEO that this was free money, that there was no way they could ever lose a penny on this. And you are telling me this is good?

Mr. BRICKELL. Well, I said it is good, it is not perfect, but I believe that it is good.

The CHAIRMAN. This is good, something that almost took down the biggest insurance company in the world?

Mr. BRICKELL. Well, if you want to shift the focus to that particular company, let's state at the outset——

The CHAIRMAN. The reality is that this is very complicated stuff, and I don't claim to understand this totally. The sad news is that I may understand this about as well as anybody in this Congress, and that is scary. Okay?

But what a lot of these guys know is about AIG. And so whether it is fact or fiction, or right or wrong, it is something you are going to have to deal with.

Mr. BRICKELL. I would be glad to answer the question. Let's state at the outset that, as helpful as swap professionals try to be, we haven't found a way to guarantee that every investor makes a profit. So I appreciate the question about AIG because it allows me to address some fundamental misperceptions about how and why they ran into difficulty.

AIG is a regulated financial institution, regulated at the Federal level. It had plenty of capital. And it took too much exposure to the wrong mortgages. They own a mortgage insurance business. They bought plenty of mortgage-backed bonds. And, on top of that, they guaranteed mortgages that were owned by others, often writing credit default swaps to do that.

They knew what positions they were taking. Their regulator knew what positions they were taking. Their regulator, according to the articles I have seen in *The Wall Street Journal,* had people who lived in their offices up in Wilton, Connecticut, in the offices of AIG–FP.

The CHAIRMAN. Well, but those are the same people that were given the road map to the Madoff situation two or three times and missed it. We don't have a lot of confidence, in this Committee, in those regulators, okay?

Mr. BRICKELL. I believe there is good reason to ask questions about the effectiveness of that oversight. AIG made bad decisions. Their Federal regulator didn't keep them from doing that. So, like you, I don't take too much comfort from the idea that a Federal regulator would help limit the activity of the counterparty.

Now, there is one important problem that AIG faced, and it is something that we warned about. I mentioned in my written testimony the Group of Thirty report on derivatives that I and others wrote 15 years ago, published in 1993, under Paul Volcker's stewardship. He was the Chairman of the Group of Thirty. He oversaw the preparation of that report.

And we said then that, if you run a company that is entering into swap contracts and you offer collateral to your counterparties and the collateral has ratings triggers, so that, for example, if you are a AAA corporation and you are not posting collateral while you are AAA, but make the arrangement to provide collateral to your counterparties when your AAA rating is lost, you have to manage the liquidity demands that that construct is going to put on your corporation.

The CHAIRMAN. But they didn't.

Mr. BRICKELL. We wrote that down 15 years ago in the Group of Thirty report. It was read by participants in the business and it was read by the regulators. So I would like to think that we tried very hard in the swaps business to be part of the solution to this kind of problem, and anticipated it by a decade and a half.

Now, we have written good advice about how to manage risk. That doesn't mean that everybody will follow it all the time. And, in this case, it seems to have been ignored.

The CHAIRMAN. Well, my time has expired. But, I mean, we may be ham-handed or not understand what we are doing here, but I think that the problem we are having is because we have one regulator out there that is trying to operate under circumstances that were in place 40 years ago when the market was a lot less complex.

One of the things we have done in this Committee is we have moved to a principles-based regulation scheme, which is what we need to do with all the regulators. We need to have the regulations follow the marketplace, and have a system whereby this risk is brought into view. That is what we are trying to do here.

I have no confidence if you are going to give this to the SEC or the Fed and a bunch of bureaucrats are going to figure this out. This is way too complicated. They are not going to know what is going on. And you guys will be so far ahead of them that it wouldn't make any difference.

So what we are trying to do is to force the risk out into the open as we go through, and not rely on the people that are doing it to do that, but have somebody independent making that decision. That is kind of what we are trying to do here. Now, how we get there, that is the question.

But something is going to happen here. And we are hoping on this Committee to help make it the most reasonable, and effective. If we are not successful, I guarantee what is going to come out is going to be a hell of a lot worse. So, I hope you will work with us, and we look forward to that.

I had a couple other questions, but I burned up all my time. So I recognize the Ranking Member, the gentleman from Oklahoma, Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman.

Mr. Concannon, you made an interesting point that NASDAQ's history is such that it was founded to bring order to the OTC equities market. Do you see similarities between that market prior to NASDAQ and the OTC derivatives market today?

Mr. CONCANNON. Absolutely. Today the OTC derivatives market is a phone-based market. The only difference of NASDAQ when it was formed and the equities market at the time was that it had centralized clearing. It allowed us to form a market around this centralized clearing and bring pricing transparency to an otherwise inefficient market.

OTC derivatives today, given the bilateral nature of the product, the product is actually priced based on your creditworthiness. That doesn't exist in things that are centrally cleared. We standardize creditworthiness through a clearinghouse and a system of margin, standardized margin, and collateral collection. So, just like any equity owner can buy a share of Microsoft and they are not judged on their status and their financial well-being, they don't pay a different price. And that can be delivered in the over-the-counter derivatives market.

I think it is important, though, that we take steps. Clearing first is an important concept here because of the nature of the market today. It is a highly complex market. And it can continue to be a phone-based market, but we can eliminate a lot of the counterparty risk by just introducing mandated clearing.

Mr. LUCAS. Thank you.

Mr. Brickell, you are critical, and it was in your written testimony, of pulling the credit risk swaps out of institutions where they reside today and forcing them into a central counterparty, because of the risk of creating a new, too-big-to-fail enterprise and the risk that would represent to taxpayers.

I kind of agree with the Chairman, there are a lot of things today that we have discussed that ignore the political reality of the world. But that being what it is, I guess my question to you is, is there a way to mutualize the risk without mandating clearing?

Mr. BRICKELL. Well, it probably comes through in my testimony that I tend to admire a system that, rather than mutualizing the risk, requires each participant to make good judgment about the quality of his counterparty.

I think you get more strength, and discipline, in the financial system if you don't mandate the mutualization, because it forces each participant to think hard about whether his counterparty is a creditworthy enterprise. I think that market discipline is something that is good for the system.

Mr. LUCAS. In the countryside, an old farmer will point out to you that, if you have a rogue bull, that he will go around and cripple all the other young bulls. It almost seems as though, by certain actions taken by certain entities and certain groups, it has been that sort of an effect on the economy and compelled us and the Administration, both past and present, to, in effect, use the Treasury to mutualize those risks. So, fascinating testimony, sir.

Mr. Chairman, I yield back.

The CHAIRMAN. I thank the gentleman.

The gentleman from Pennsylvania, Mr. Holden.

Mr. HOLDEN. Thank you, Mr. Chairman.

Mr. Concannon, can you describe for the Committee the measures that your derivatives clearing operation has in place to ensure it can survive the financial stress of any of its members?

Mr. CONCANNON. Absolutely. Because it is approved by the CFTC, the CFTC requires certain risk measures that are built in to the system. A deposit is required by every member. An initial clearing fund is built and required. And then variation margin, daily variation margin, which is set by the CFTC based on the product construct, is also required. We will collect margin every day. We will calculate the margin twice a day.

That is very different than how the OTC derivatives market is conducted today, where clearly good judgment, as Mr. Brickell uses, failed us. In certain instances, OTC derivative traders will not collect margin. If you are a large hedge fund that does a lot of business with an individual bank, there are times where they may not, and they certainly have the discretion to not, collect margin for you on a given day or a given week. And so, it is that good judgment that actually failed us in 2008.

Mr. HOLDEN. Thank you.

Mr. Hale, you mentioned that, had the draft bill been in place last year, Cargill would not have been able to offer the simple swaps that allowed it to restart its market for making deferred purchases from crop producers.

Why would a clearing requirement prevent you from entering into swaps, especially those of simple nature such as those that you mention in your testimony?

Mr. HALE. It would have to do with the capital requirements to be extending margin upon those transactions if they were cleared on a daily basis. In many cases, customers and even Cargill at times was nearing its point of its borrowing limit. So, if we had been forced to put up capital on a daily basis for margin, it may have had us leave the market earlier than we did actually.

Mr. HOLDEN. Thank you.

I yield back, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The gentleman from Kansas, the Ranking Member of the Subcommittee, Mr. Moran.

Mr. MORAN. Mr. Chairman, thank you very much.

Mr. Hale, as I understand the testimony from yesterday and today, there is a common theme from witnesses. And it seems, whether it is the exchanges or the brokers or commercial market participants, there seems to be exception taken with section 6 and section 13. All seem to believe that the definition of *bona fide* hedging is too narrow and that mandatory clearing is a good idea but impractical.

One thing you mentioned in your testimony is that you do not want position limits to apply to the swap dealer but, rather, to the person who trades on both the designated market and over-the-counter market. The difference here is that we have two separate markets where speculative position limits would apply.

My question is, which market should the trader reduce his position in, the DCM or the OTC market; or should the trader decide that?

Mr. HALE. I am not sure I understood your question exactly, sir.

Mr. MORAN. Well, it is hard to always understand the testimony, but it seemed to me that you don't want position limits to apply to the swap dealer but, rather, the person who trades on the OTC or the designated market. And my question is, who decides where the trader reduces his or her position; if it exceeds the position?

Mr. HALE. Well, we said we have been in favor of aggregated position limits across OTC and exchange. So, assuming they still had room in either exchange or their OTC limit, I would think that the individual who is asking to make the swap would make that decision.

As a provider, we are creating swaps across multiple counterparties. And if, in fact, we are put on a limit, if the providers put on a limit such as a market participant, then basically the market is going to shrink, because the provider is not going to be there to be able to make the market for them.

Mr. MORAN. Thank you.

To anybody on the panel, many of our panelists believe that the bill as written that mandates clearing, with a narrow exception for the CFTC to grant a case-by-case exemption, is not practical. Looking for alternatives, if you clear your OTC trade, your trade will remain a regulated swap, exempt or excluded commodities as stated in the Chairman's draft.

If you choose not to clear your over-the-counter trade, because it is not structured for clearing, or maybe you don't want to clear it for proprietary reasons, what if we established a set of core principles, similar to those which the exchanges are now subject to? Those core principles would give direction about how counterparties to an OTC trade must post margin or make adjustments to capital accounts.

Would this be a method by which we would avoid mandatory clearing, and, yet, still protect traders in the market as a whole from the type of market default that we are concerned with?

Mr. CONCANNON. I will try to answer that.

Well, obviously, we stated that we support the provision mandating clearing. I think it is critical that the CFTC, who does have the expertise to create exemptions, does in fact create exemptions. We don't believe all things OTC can be centrally cleared. Obviously, there are numerous complexities and unique products that will never be able to be cleared centrally.

I think there are a number of ways, similar to the one you referenced, that will entice end-users to use a cleared product. But when they need the unique nature of the OTC product, they will pay the cost of using the OTC product.

So, whether it is the capital charges that currently exist and increasing capital charges for carrying an OTC position, whether it is tax treatment and tax benefits to the extent you move to a cleared *versus* an OTC treatment. There are numerous ways outside of mandating that can strongly encourage central clearing.

Mr. COOPER. I think we also agree largely with those thoughts. An incentive scheme that would give market participants the economic incentive to clear is probably a very workable alternative.

Mr. HALE. If you would allow, Mr. Dines would like to comment on that question.

Mr. DINES. I think it is a very interesting option to come up with some core fundamentals. I would just like to make one point, if I could.

As an OTC provider today, we are already doing many of the things that centralized clearing does. We send our customers a daily position report that has updated pricing with updated valuations. We are also collecting margin, passing margin back and forth every day with our customers. And we are doing that for the bulk of our customers. So some of the same things that we are talking about achieving in centralized clearing are already happening in the OTC area.

And, as far as getting to the greater transparency, greater reporting side of things, as an OTC provider, we are already doing that through our special calls now that we are doing with the CFTC. And we think that that should be standardized and put on a more regular basis, and that would get to a lot of what you are trying to achieve.

Thank you.

Mr. HALE. Thank you, Mr. Chairman.

The CHAIRMAN. I would just say you all have made valid points. The problem is—I am not talking about you—but, within the Congress, nobody trusts you guys, okay? That is part of what we are dealing with here. You know, you probably could do all of this, but people right now are having a hard time believing that is going to happen. And that is part of what we are dealing with here.

The Chairman of the Subcommittee, Mr. Boswell from Iowa.

Mr. BOSWELL. Well, thank you, Mr. Chairman. I appreciate the discussion that is going on here.

Maybe one point here to Mr. Concannon. As the market sorts out the various proposals for clearing derivatives traded in the OTC derivatives markets, we see the potential for regulation of the clearing that is being conducted by the Fed and the SEC, as well as the CFTC.

In your view, does this arrangement make sense? What is the most sensible regulatory approach to clearing in this area, if you will?

Mr. CONCANNON. Well, today we are regulated by both the CFTC and the SEC. We haven't added the Fed to that list yet. I think it is critical that we have one regulator and that that regulator, regardless of its name, uses a principle-based regulatory approach.

As we travel the world, we have exchanges around the globe where we interact directly with regulators around the globe, and we find the great majority are using principle-based regulation, as the CFTC does today. It allows exchanges the flexibility to bring new products into the market, similar to the OTC products, into a market, and centrally cleared, where investors are better suited and better protected.

So I would say, without naming the name of the single regulator, we do support a single regulator of all these instruments.

Mr. BOSWELL. Anybody else want to comment?

Mr. COOPER. We, NYSE Euronext, would also strongly support a principle-based regulatory approach to help us deliver the solutions that Congress is looking for, centralized clearing, exchange-traded solutions.

Thank you.

Mr. BOSWELL. Can I assume that you agree with most of us that it ought to be here with the CFTC?

Mr. COOPER. For the centralized clearing of OTC derivatives, yes.

Mr. BOSWELL. Interesting. I yield back.

The CHAIRMAN. I thank the gentleman. The gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman.

Mr. Brickell, the Chairman noted in response to your testimony that we are not quite as comfortable as you appear to be with private-market discipline as the answer to the current crisis, because folks like you 30 years ago, as you pointed out, made various recommendations to the market concerning how it should discipline itself and it just didn't happen.

I can easily imagine the sort of pressures that are on traders and institutions as far as profits and bonuses, *et cetera,* are concerned, agree to swaps, hedges, those sorts of things that can make their books look a little bit better when in fact they are not. It would be enormously challenging to regulators to come in and take a look at those books. And you are right, the regulator does have access, where the big banks are concerned, to the details of every swap. The problem is, the regulator doesn't really have access to the circumstances of the counterparty or the others that the counterparty is relying on. And the web that is created is one that is quite challenging.

Maybe in a better world where you could rely on all individuals to act appropriately with regard to gauging risk, dissemination of the risk over a wide number of people as opposed to concentrating it in single institutions is probably a very good idea. But what has happened here is there have been various market failures, and the upshot is that we end up plugging in a whole bunch of money and more money. And worse than that, actually, is a total collapse of the economy which has just hurt all kinds of people.

We are headed in the direction of greater regulation, and we just appreciate the help from folks like you in trying to guide us to regulation that doesn't do too much damage in the course of doing more than you would want us to do.

I would be delighted to talk a little bit further with you about this. But, it would be useful to the Committee to hear from two folks here that are not really all that interested in paying fees to a clearinghouse to comply with what the Committee would like to do in order to lessen systemic risks. And a couple of folks here are representing clearinghouses, saying we really ought to have clearing, and also suggesting we ought to come up with some sort of incentives to encourage the folks that don't really want to incur these fees associated with clearing, to clear.

I am kind of curious to know what kind of fees and margining, *et cetera*, do you anticipate that would really dampen the market. I guess that would be Mr. Hale and Mr. Cicio. And then a quick response from those who are favoring clearing that no, they are not being realistic here, the market will go on, it is not going to die, it is not going to substantially contract, those sorts of things.

What are the fees and problems you anticipate with being required to clear? And let's assume that there is a willingness to clear. Obviously, there are going to be some transactions people won't be willing to clear, and then some are going to just be too customized to fool with them. It is just too much.

Mr. HALE. I don't know exactly how the fees would be structured as yet, but if they are similar to the regular futures contracts, you are going to have an initial margin fee to put up, there will be transactional costs and there is daily margining as the market changes. So there is going to be working capital costs to the participant in that case as well as transactional costs, which don't exist today to that full extent in the OTC market. There are margins.

Mr. MARSHALL. Is that the principal thing that you are trying to avoid, is those enhanced costs?

Mr. HALE. I think it is really that, and what it does to our customers who are going to have to provide that margin today, where we may have credit agreements with them, where they don't have to do that.

Mr. MARSHALL. That is where Mr. Brickell would say, let private market discipline handle the margining requirements day to day and they will make wise decisions. It sounds like Alan Greenspan again, and it just doesn't seem to have worked real well recently.

Mr. HALE. Right. It has worked fairly well in the agricultural markets. I mean, we haven't really had any significant meltdowns in that regard. Now, it doesn't mean it can't happen. I am not naïve enough to try and tell you that. But I think that the system we have today is working quite well. There is an extreme amount of due diligence that goes on in assessing credit risks with our customers. So that is going on on a daily basis.

Frankly, whether you have a transaction that goes through a clearinghouse or individually, it is not necessarily going to guarantee performance. There have been defaults on the clearinghouse, and so it is not a guarantee that there is going to be performance in the end.

Mr. MARSHALL. Mr. Cooper? Mr. Concannon? Should they be concerned about margining requirements and fees?

Mr. COOPER. Well, apparently they are. Yes, there would be these additional initial margin payments that don't exist in the over-the-counter marketplace. How significant that would be, I don't know. I suspect that we are just hearing about, sort of as a hypothetical matter, an initial margin payment. Any one of the market participants, market position, the initial margin payment that is due on Monday may be offset by variation credits they are getting for mark-to-market on their position in the clearinghouse on Friday. So it is not clear exactly what the impact would necessarily be, would be as great as they fear.

Mr. MARSHALL. Mr. Chairman, earlier you noted or you suggested in response to Mr. Brickell's testimony that the effect of all of this really has been to permit these folks to margin out more. And, truly, even for cautious institutions, the effect has been that people get comfortable and take on way too many risks. We saw that with AIG making all kinds of mistakes, but some of the other institutions as well.

So whether you call it leveraging or not, I guess you would say yes, there is a cost associated with this, Mr. Cooper, Mr. Concannon, those who are offering clearing. But, maybe it is a cost society needs to require that folks bear and come up with some way to encourage people to bear it, and maybe we come up with some way to try and minimize it.

Competition might be good. Do you expect there is going to be just one clearinghouse ultimately?

Mr. COOPER. We certainly have long been advocating competition in the over-the-counter clearing solution space, and that would be beneficial to the country and to the global marketplace, to offer alternatives and let the marketplace decide who are the strongest competitors and who offers the best solutions.

Mr. MARSHALL. My time has expired some time ago, 2 minutes ago, and I appreciate the Chairman's indulgence. Obviously we could go a lot longer. We don't have other Members at the moment, so we are not going to have additional questions

The CHAIRMAN. We have another panel. So I would like to wrap up. I thank the gentleman.

I thank this panel for being with us and for your good testimony and answers. We will be in further discussion with you, I am sure, as we move through this process. You are dismissed.

We have one more panel to get through today. While we are making the transition, I am going to introduce the panel.

We have Mr. Thomas Book, who is a Member of the Executive Boards, of Eurex Deutschland and Eurex Clearing AG of Frankfurt, Germany.

Mr. Stuart Kaswell, General Counsel of Managed Funds Association of Washington, DC.

Mr. Edward Rosen, Partner, Cleary Gottlieb Steen & Hamilton LLP, on behalf of the Securities Industry and Financial Markets Association.

Mr. Brent Weisenborn, CEO of Agora-X, LLC, of Parkville, Missouri.

And Mr. Donald Fewer, the Senior Managing Director, Standard Credit Group, LLC, of New York, New York.

So welcome to the Committee. Your complete statements will be made part of the record. We would encourage you to summarize your statements.

Mr. Book, you will begin. Welcome to the Committee.

STATEMENT OF THOMAS BOOK, MEMBER OF THE EXECUTIVE BOARDS, EUREX AND EUREX CLEARING AG, FRANKFURT AM MAIN, GERMAN

Mr. BOOK. Chairman Peterson, Ranking Member Lucas, Members of the Committee, I appreciate the opportunity to testify before you today. I thank the Committee for calling this hearing on this important piece of legislation.

I am Thomas Book, a Member of the of the Executive Boards of Eurex and Eurex Clearing. I have overall responsibility for management of the clearing business. Eurex Clearing is one of the leading clearinghouses in the world and is by far the largest European clearinghouse. It is licensed and supervised by the German Federal Financial Supervisor Authority. It is also recognized by the U.K.'s Financial Services Authority.

Eurex and Eurex Clearing understands the importance of public confidence in the derivative markets. We support the Committee's efforts to increase transparency and to ensure appropriate regulation of the over-the-counter markets.

Eurex Clearing strongly endorses the provision of section 13 of the draft bill that permits any number of clearinghouses to act as CCP for OTC transactions in excluded commodities. Eligible CCPs could be supervised by the CFTC, the SEC, the Federal Reserve, or by a foreign regulator that meets appropriate standards. Such a non-U.S. clearinghouse is termed a multilateral clearing organization.

This approach recognizes the high degree of competence of each of the U.S. financial regulators, and of many foreign regulators, to establish and enforce an appropriate level of supervision and oversight of the activities of the CCPs.

However, for overseas transactions in exempt commodities, such as contracts on energy or precious or base metals are, the bill would permit only a CFTC-recognized derivatives clearing organization to act as a CCP. Eurex Clearing strongly encourages the Committee to amend the bill and permit non-U.S. multilateral clearing organizations to clear OTC contracts on exempt commodities if the CFTC has found that the applicable foreign regulator meets appropriate standards.

Turning now to section 3 of the bill, foreign boards of trade such as Eurex, that are eligible to permit their U.S. members to directly access their markets, would be required to meet certain enhanced conditions with respect to contracts that settle to the prices of U.S. markets.

It should be noted that the information collection systems of other countries may differ. For example, non-U.S. markets may collect information on large positions only during the spot month or only during the period preceding contract expiration. Accordingly, we recommend that the bill be modified to include room for such differences by explicitly permitting the CFTC to accept comparable alternative methods of market surveillance on the part of the foreign board of trade or the foreign regulatory authority.

One of the boldest provisions of the proposed bill is the section 13 requirement that all derivative transactions, unless exempted by the CFTC, be submitted for central counterparty clearing. Eurex Clearing strongly supports clearing of OTC transactions as a means of safeguarding market integrity and the stability of the financial system.

We firmly believe that the enhanced transparency of a neutral clearinghouse would have alerted market participants to the risk of their positions at an earlier time, resulting in much smaller losses. However, not all OTC transactions will be suitable for CCP-style clearing. Such noncleared transactions, nevertheless, serve *bona fide* economic purposes. To address this reality, the bill provides a mechanism whereby the CFTC can exempt certain kinds of nonstandardized transactions from the clearing requirement.

Eurex Clearing believes that it is important that this exemptive authority be implemented in a practical way that preserves the vitality of the OTC markets. We believe that the CFTC should use its exemptive authority liberally.

I would also note that we are concerned by the proposal in the draft bill to prohibit naked purchase of credit default swaps. We believe that this provision would seriously impair the functioning of the CDS market to the detriment of its many legitimate and valuable uses.

Finally, I would like to share with you the same thoughts we have expressed to the European Commission. We have strongly supported the Internal Market Commissioner Charlie McCreevy's call for action to improve market infrastructure for OTC clearing, and, in particular, for credit default swap clearing. We believe that improvements in Europe are of common interest to all market participants because they will also contribute to market stability on a global scale.

This Committee's deliberations provide an important opportunity to improve market infrastructure and the efficiency of the global financial system. For this reason we applaud Chairman Peterson for driving much-needed change to the OTC market structures. I appreciate the opportunity to discuss these critically important issues with the Committee and I am happy to answer your questions.

[The proposed statement of Mr. Book follows:]

PREPARED STATEMENT OF THOMAS BOOK, MEMBER OF THE EXECUTIVE BOARDS, EUREX AND EUREX CLEARING AG, FRANKFURT AM MAIN, GERMANY

Chairman Peterson, Ranking Member Lucas, Members of the Committee, on behalf of Eurex Deutschland ("Eurex") and Eurex Clearing AG ("Eurex Clearing") I would like to express our appreciation for this opportunity to testify before you today and to thank the Committee for calling this hearing on this important piece of legislation, the "Derivatives Markets Transparency and Accountability Act of 2009." My name is Thomas Book. I am a Member of the Executive Board of Eurex as well as Eurex Clearing and have overall responsibility for management of Eurex Clearing. Eurex and Eurex Clearing are part of the Deutsche Börse Group.

Eurex and Eurex Clearing understand the importance of public confidence in the derivatives markets and support the Committee's efforts to increase transparency and ensure appropriate regulation of these markets. As Reto Francioni, the Deutsche Börse Group CEO, emphasized last week at the Group's annual New Year's reception:

> At Deutsche Börse . . . we have always seen it as an advantage—in terms of transparency and fairness—that we are subject to regulation and supervi sion . . . . Through the crisis, we have seen—and still see—that particularly where market organization was neither effectively and efficiently regulated . . . those cases were characterized by unfairness and opaqueness and resulted in extraordinary damages.

Eurex and Eurex Clearing are key international exchange and clearing services providers

As I testified previously before this Committee,[1] Eurex is one of the largest derivatives exchanges in the world today. Eurex is in fact the largest exchange for Euro-denominated futures and options contracts. While it is headquartered in Frankfurt, Germany, Eurex has 405 members located in 22 countries around the world, including 74 in the United States.

Eurex Clearing is one of the leading clearinghouses in the world and by far the largest European clearinghouse. Eurex Clearing acts as the central counterparty ("CCP") for all Eurex transactions and guarantees fulfillment of all transactions in futures and options traded on Eurex, all transactions on other Deutsche Börse Group exchanges and trading platforms, transactions on several independent exchanges, and transactions executed over-the-counter ("OTC"). Eurex Clearing is directly connected with a number of national and international central securities depositories, thereby simplifying the settlement processes of physical securities for its clearing members. As Europe's largest and one of the world's leading clearing houses, Eurex Clearing clears more than two billion transactions each year. Eurex Clearing has over 125 clearing members. It currently does not operate in the United States and has no U.S. clearing members,[2] although through its clearing members it does indirectly clear trades on behalf of Eurex's U.S. members.

Eurex Clearing is highly experienced in offering fully automated and straight-through post trade services for derivatives, equities, repo, energy and fixed income transactions. Besides clearing transactions executed on exchange, Eurex Clearing also accepts, novates, nets and guarantees a broad range of derivatives transactions from the over-the-counter markets on the same basis that it clears exchange-traded

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[1] *Hearing To Review the Role of Credit Derivatives in the U.S. Economy:* Hearing before the House Committee on Agriculture, 110th Cong, 2d sess. (December 8, 2008) (statement of Thomas Book, Member of the Executive Board, Eurex and Eurex Clearing).

[2] However, a number of its members are European affiliates or parents of U.S. entities. In addition, Eurex Clearing has an agreement with The Clearing Corporation relating to the operation of a clearing link between Germany and the United States.

contracts. Eurex Clearing's OTC clearing business is growing and accounted for about 40% of the total cleared derivatives volume last year. As we discussed in our Testimony to this Committee last December, like a number of other major derivatives clearinghouses, Eurex Clearing is developing clearing services for the Credit Default Swaps market.

High Degree of Regulation Applies

Eurex Clearing is required to be licensed as a CCP by the German Federal Financial Supervisory Authority ("BaFin"). In addition, on January 16, 2007, Eurex Clearing was recognized by the United Kingdom's Financial Services Authority ("FSA") as a Recognized Overseas Clearing House ("ROCH"), on the basis that the regulatory framework and oversight of Eurex Clearing in its home jurisdiction is based on common principles and practices to those of the FSA.

As noted in our prior testimony to this Committee, the German Banking Act ("Banking Act") provides the legal foundation for the supervision of banking business, financial services and the services of a CCP in Germany. The activity of credit and financial services institutions is restricted by the Banking Act's qualitative and quantitative general provisions. These broad, general obligations are similar to the Core Principles of the Commodity Exchange Act which apply to U.S. Derivatives Clearing Organizations ("DCOs"). A fundamental principle of the Banking Act is that supervised entities must maintain complete books and records of their activities and keep them open to supervisory authorities. BaFin approaches its supervisory role using a risk-based philosophy, adjusting the intensity of supervision depending on the nature of the institution and the type and scale of the financial services provided.

The Banking Act requires that a CCP have in place suitable arrangements for managing, monitoring and controlling risks and appropriate arrangements by means of which its financial situation can be accurately gauged at all times. In addition, a CCP must have a proper business organization, an appropriate internal control system and adequate security precautions for the deployment of electronic data processing. Furthermore, the institution must ensure that the records of executed business transactions permit full and unbroken supervision by BaFin for its area of responsibility.

BaFin has the authority to take various sovereign measures in carrying out its supervisory responsibilities. Among other things, BaFin may issue orders to a CCP and its Executive Board to stop or prevent breaches of regulatory provisions or to prevent or overcome undesirable developments that could endanger the safety of the assets entrusted to the institution or that could impair the proper conduct of the CCP's banking or financial services business. BaFin may also impose sanctions to enforce compliance. BaFin has the authority to remove members of the Executive Board of an institution or, ultimately, to withdraw the institution's authorization to do business.

In addition, the German Federal Bank ("Deutsche Bundesbank") coordinates and cooperates, with BaFin, the primary regulator, in the supervision of Eurex Clearing. Deutsche Bundesbank plays an important role in virtually all areas of financial services and banking supervision, including the supervision of Eurex Clearing. Under the Banking Act, Deutsche Bundesbank exercises continuing supervision over such institutions, including evaluating auditors' reports, annual financial statements and other documents and auditing banking operations. Deutsche Bundesbank also assesses the adequacy of capital and risk management procedures and examines market risk models and systems. Deutsche Bundesbank adheres to the guidelines issued by BaFin. As appropriate, Deutsche Bundesbank also plays an important role in crisis management.

Both supervisory authorities use a risk-based approach to oversight, under which the supervisory authority must review the supervised institutions' risk management at least once a year to evaluate current and potential risks. In so doing, the supervisory authority takes into account the scale and importance of the risks for the supervised institution and the importance of the institution for the financial system. Institutions classified as of systemic importance, including Eurex Clearing, are subject to intensified supervision by both supervisory authorities.

The Derivatives Markets Transparency and Accountability Act of 2009

As many have observed, the derivatives markets, both exchange-traded and OTC, are global in nature. Accordingly, Eurex and Eurex Clearing have a critical interest in, and potentially will be affected by, this Committee's deliberations. Eurex and Eurex Clearing view the proposed Derivatives Markets Transparency and Accountability Act of 2009 (the "DMTAA") as an important piece of legislation which will increase oversight and transparency of the OTC and exchange-traded derivatives markets. We commend the Committee for taking the initiative to address some of the thorniest issues that confront the financial markets in this period of economic crisis and support the Committee's efforts to ensure that these markets are appropriately regulated. With that as background, I am pleased to provide specific comments on the draft DMTAA.

The DMTAA Appropriately Recognizes Global Markets

Section 3 of DMTAA has three sub-sections. The first would establish conditions that the Commodity Futures Trading Commission ("Commission") must apply in granting Foreign Boards of Trade ("FBOT") permission to provide direct market access to their trade matching system from the U.S. for contracts that settle against any price of a U.S. registered entity. These conditions include providing transparency with respect to certain daily trading information relating to such contracts, providing similar position accountability or speculative position limits as the U.S. registered entity imposes and providing information to the Commission with respect to large trader information. Although Eurex has been granted permission to provide direct market access to its U.S. members,[3] it does not currently list any contracts which would be subject to the additional section 3 requirements. Nevertheless, if in the future Eurex determines to list such a contract and make it available by direct market access from the U.S., it would be subject to these conditions.

First, it should be noted that section 3 of the DMTAA builds upon the foundation of the current procedures for reviewing and considering requests by FBOTs to provide direct market access from the U.S.[4] Eurex strongly supports the current procedures. The current process is premised upon the underlying concept of "mutual recognition" of international regulatory frameworks. It is based upon two broad principles: (1) the conduct by the Commission of a thorough pre-admission due diligence review to ensure that the FBOT is a *bona fide* market subject to a comparable regulatory scheme, and (2) recognition that the home country regulator is responsible in the first instance for regulation and oversight of the operation of the foreign market.

This U.S. approach has been widely accepted internationally and with the application by foreign regulatory authorities of broadly similar procedures to permit direct market access by U.S. exchanges in their jurisdictions, provides an important baseline of international regulatory requirements which has been critical to the ability of both U.S. and foreign derivatives exchanges to operate global electronic trading systems. This has been accompanied by an increased level of consultation and cooperation between and among national regulators.

The pre-admission due diligence review conducted by the Commission is extensive and thorough. In permitting FBOTs to establish direct market access from the U.S., the Commission imposes conditions that the FBOT must fulfill.[5] The DMTAA builds upon this foundation, requiring that additional transparency, reporting and other requirements apply for direct market access by the foreign market with respect to contracts that settle to prices of a U.S. registered entity.

The DMTAA provides that where markets are linked through the use of one another's settlement prices, enhanced conditions for access will be applied. However, not all jurisdictions apply speculative position limits or position accountability rules in the same manner as U.S. markets. Markets may rely on other regulatory powers or authorities to fulfill their market surveillance obligations, especially for commodities that do not have limited deliverable supplies. Accordingly, we recommend that

[3] *See* Letter of the Commodity Futures Trading Commission Division of Trading and Markets, dated August 10, 1999, at: *http://www.cftc.gov/tm/letters/99letters/tmeurex__no-action.htm.*

[4] The Commission on November 2, 2006, adopted a formal policy statement with respect to the procedure to be used in reviewing and granting permission to FBOTs to provide direct market access to their trade matching engines from the U.S. "Boards of Trade Located Outside of the United States and No-action Relief from the Requirement to Become a Designated Contract Market or Derivatives Transaction Execution Facility," 71 *Fed. Reg.* 64443 (November 2, 2006) ("Commission Policy Statement").

[5] These conditions include, among others, appointment by the FBOT of a U.S. agent for receipt of Commission communications, assent by the FBOT's members operating under a No Action letter to the jurisdiction of the Commission and appointment of a U.S. agent to receive legal process, a number of requirements relating to maintenance and accessibility of original books and records and required reporting by the FBOT to the Commission of specified information both on a periodic and special request basis. FBOTs must also keep the Commission informed of any material changes to their operations and the home country regulations under which they operate and must stand ready to demonstrate compliance with the conditions of the No-action relief. Finally, the FBOT must notify the Commission ten days prior to listing new contracts for trading from its U.S. terminals and must request supplemental relief with respect to contracts subject to section 2(a)(1)(B) of the Commodity Exchange Act. See e.g. *http://www.cftc.gov/tm/letters/tmeurex__no-action.htm* at 14.

the DMTAA be modified to explicitly permit the Commission to accept comparable or alternative methods of market surveillance on the part of the FBOT or the foreign regulatory authority. In this regard, it should be noted that foreign markets or jurisdictions may collect information on large positions, but may do so only during the spot month or only during the period preceding contract expiration, or may not routinely aggregate such information across trading members' accounts. Such a framework should be understood nevertheless as being able to meet the conditions of section 3 of the DMTAA.

The second subsection of section 3 of the DMTAA provides that a Commission registrant shall not be found to have violated the Commodity Exchange Act ("Act") if the registrant believes the futures contract is traded on an authorized FBOT and the Commission has not found the FBOT to be in violation of the exchange-trading requirement of the Act. The third subsection provides that a contract executed on a FBOT will be enforceable even if the FBOT fails to comply with any provision of the Act. Eurex supports both of these provisions which will provide greater legal certainty with respect to trading on non-U.S. markets. This greater level of legal certainty is appropriate in the face of the increasing globalization of trading. Although Eurex endeavors to be in compliance at all times with all provisions of the Act that apply to it, the third subsection will provide all U.S. participants in a foreign market with greater certainty with respect to the enforceability and finality of the contracts which they trade.

The DMTAA will encourage clearing of OTC derivatives, including CDS

Section 13 of the DMTAA seeks to bring greater transparency and accountability to the derivatives markets by requiring that OTC contracts, agreements and transactions in excluded commodities (mainly interest rates, equity indexes and other types of financial instruments) be cleared by: (1) a DCO registered by the CFTC; (2) by an SEC registered clearing agency; (3) by a banking institution subject to the supervision of the Federal Reserve System; or (4) by a clearing organization that is supervised by a foreign financial regulator that a U.S. financial regulator has determined satisfies appropriate standards. This last category of approved clearing organization is a multi-lateral clearing organization ("MCO") recognized under section 409(b)(3) of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"). Section 13 of the DMTAA further provides that OTC contracts, agreements or transactions in exempt commodities (mainly energy, precious metals and possibly emissions or carbon rights) would be required to be cleared through a CFTC-registered DCO.

Eurex Clearing strongly supports clearing of OTC transactions as a means of safeguarding market integrity and the stability of the financial systems. Eurex Clearing believes that clearing OTC derivatives provides undeniable benefits not only to the individual clearing participant but to the entire financial market as well by enhancing transparency, avoiding undue concentrations of risk positions, and providing a system to contain and reduce systemic failures. We firmly believe that the enhanced transparency of central counterparty clearing by a neutral clearinghouse would have alerted market participants to the risk of their positions at an earlier time, resulting in much smaller trading losses, and potentially avoiding some of the extraordinary mitigation efforts that have ensued.

To be sure, a derivatives clearinghouse is not a panacea, but, with regard to our current financial turmoil, clearing might in many instances have prevented entities from building unsustainable positions. The twin disciplines of marking positions to market and collecting collateral, or margin, are market mechanisms that are the very heart of the value of CCP clearing. These market mechanisms are very efficient at discouraging the build-up of unaffordable risk. Also, direct access to clearing services is, by its nature, limited to creditworthy institutions—the clearing members—who are willing and able to mutualize their counterparty risk. Because of this structure, exchange-traded derivatives or those that were traded OTC but subsequently submitted for CCP clearing, have not been an issue during the current market crises. Derivatives clearinghouses on both sides of the Atlantic have functioned well and, by doing so, have assured that CCP-cleared derivatives markets continue to provide their crucial risk shifting and price discovery functions.

CCP clearing has previously not been available for credit default swaps ("CDS"). Eurex Clearing is confident that CCP clearing of CDS will help ameliorate systemic risk for the financial markets by mitigating counterparty risk and by enhancing transparency regarding exposures, the sufficiency of risk coverage, operational weaknesses, and technical capacity shortfalls. Given the huge, widely held exposure in CDS contracts, robust clearinghouses are needed to act as the central counterparty to these trades.

As we detailed in our prior Testimony to this Committee, Eurex Clearing has been working with ISDA, Deriv/SERV, international banks and dealers, major buy-side firms and European public authorities to launch clearing services for Euro-denominated CDS by the end of this calendar quarter.

The DMTAA appropriately encourages competition among providers of OTC clearing services

We note that one of the boldest provisions of the proposed bill is the requirement that all derivatives transactions, unless exempted by the Commission, be cleared. We further note that OTC contracts in excluded commodities could be cleared by a registered DCO, by a clearing house supervised by the SEC or the Fed, or by an MCO supervised by a foreign regulator that has been recognized by a U.S. regulator as meeting appropriate standards ("Foreign Regulated MCO").

Eurex supports DMTAA's provision of permitting a number of clearing houses to offer clearing services for OTC contracts, agreements or transactions in excluded commodities. The alternative of mandating that only a single clearinghouse be licensed by an identified regulator to clear all OTC transactions world-wide would be contrary to the public interest. That type of mandated industry-wide monopoly or utility generally has reduced incentives to maximize efficiencies and innovation.

Accordingly, Eurex Clearing supports the approach adopted by DMTAA of permitting market participants to decide which clearinghouse to use from a number of possible clearing houses. Moreover, the DMTAA's provision which would permit such clearinghouses to be supervised by one of several possible U.S. regulators or by a foreign regulator that has been found by a U.S. financial regulator to meet appropriate standards recognizes the high degree of competence of each of the U.S. financial regulators, and of many foreign regulators, to establish and enforce an appropriate level of supervision and oversight of the activities of the CCPs. In this regard, the DMTAA addresses possible issues of overlap and duplication among the several regulators by requiring consultation by the Commission with the other regulators and by sharing of information. Eurex commends this legislation for addressing these potential problems.

The DMTAA Should Permit Foreign Regulated MCOs to Clear Exempt Commodity Transactions

Section 13 of the DMTAA would require that all CCPs for transactions with respect to OTC contracts, agreements or transactions on exempt commodities be registered with the Commission as a DCO. Although DMTAA may be premised on the assumption that the Commission should exercise oversight of CCP clearing of OTC transactions in which the underlying is a commodity and not a financial instrument, section 13(b) of the DMTAA unnecessarily restricts a Foreign Regulated MCO from acting as a CCP for such transactions. As currently drafted, the DCO requirement in the DMTAA seems to erect an unnecessary barrier to well-regulated foreign competition which may undermine the Act's general promotion of competition to assure efficiency and encourage innovation.

Eurex Clearing currently does not operate in the United States but would like to consider offering clearing and other services here in the future with respect to OTC contracts, agreements and transactions on excluded commodities, and may also consider offering such services with respect to exempt commodities.

At the moment, Eurex Clearing is not registered with the CFTC. In this regard, Eurex Clearing notes that it is in discussions with staff of the Commission regarding applying for Commission recognition as a Foreign Regulated MCO. We further note that several non-U.S. clearinghouses previously have been so recognized. Of the currently recognized Foreign Regulated MCOs, all may act as CCPs for OTC contracts on exempt commodities.[6] Eurex Clearing strongly encourages the Committee to amend the DMTAA to include transaction clearing of OTC contracts on exempt commodities by a Foreign Regulated MCO so long as the Commission has approved the foreign regulator of the MCO as meeting appropriate standards.

This change would reflect the fact that the Commission, in administering the provisions of section 409 of FDICIA, has significant experience in reviewing the standards of foreign regulatory authorities to ensure that they are appropriate. In this regard, the Foreign Regulated MCO process is a form of mutual recognition which facilitates the operation in the U.S. of foreign clearing organizations which the CFTC has found are subject to comparable regulation in jurisdictions with com-

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[6] They are, ICE Clear Europe, MCO Order issued on August 31, 2008; NetThruPut, Order Issued February 27, 2006; and Nos Clearing Asa, Order issued January 11, 2002. At least two, NetThruPut and Nos Clearing act as CCPs for exempt commercial markets on exempt commodities.

parably rigorous regulation. Furthermore, the CFTC requires that adequate information-sharing agreements with the foreign regulator are in place.

In reviewing applications by a Foreign Regulated MCO for an Order under section 409 FDICIA, the Commission determines whether the foreign CCP is subject to oversight by its home country regulator comparable to that which the Commission requires of U.S. DCOs in meeting the Core Principles. Accordingly, the Commission reviews both applications for DCO registration as well as requests for an Order recognizing a Foreign Regulated MCO in relation to the standards established by the Core Principles for Derivatives Clearing Organizations.

For this reason, Eurex Clearing also supports the DMTAA provision that would require a Foreign Regulated MCO to comply with requirements similar to the requirements of section 5b and 5c of the Act and the DMTAA's addition of three new Core Principles relating to daily publication of pricing information, fitness standards and disclosure of operational information. Eurex Clearing already meets all existing and proposed Core Principles and believes that these are an appropriate requirement for any foreign CCP wishing to operate in the U.S. as a Foreign Regulated MCO.

DMTAA Provides a Useful Mechanism for Exempting Transactions from the Clearing Requirement

Eurex Clearing firmly believes that central clearing services are the most suitable option effectively to mitigate counterparty risk and to improve market transparency. These are key elements in any effort toward a sustainable reduction in risk on a global scale and we support all voluntary efforts to increase the availability and use of CCP clearing for OTC transactions. In this vein, we applaud the Committee's recognition of the important role that derivatives clearinghouses provide in stabilizing the world's financial markets.

As the DMTAA recognizes, not all OTC transactions will be suitable for CCP style clearing. Such transactions may nevertheless serve *bona fide* economic purposes. To address this reality, the DMTAA provides a mechanism whereby the Commission can exempt certain types of non-standardized transactions from the clearing requirement. The Commission's determination would be based upon several factors, including the degree of customization of the transaction, the frequency of such transactions, whether the contract serves a price discovery function and whether the parties have provided for the financial integrity of the agreement. Eurex Clearing believes that these factors are the correct criteria to consider in making a determination that a transaction or class of transactions should be exempt from the clearing requirement.

Conclusion

Eurex Clearing supports the Committee in its efforts to encourage greater use of CCPs. We are ourselves working to secure the commitment by financial institutions to participate in the development of and to use the services of our CDS clearing offering.

Eurex Clearing understands the importance of public confidence in these markets and is committed to the utmost level of cooperation with the regulatory authorities in Europe and the U.S. We appreciate the opportunity to work with the U.S. regulatory authorities with respect to our plans to offer clearing services for CDS transactions.

Eurex Clearing also believes that the existing treatment of derivatives clearinghouses which envisions the possibility of more than one CCP offering its services to the OTC markets supervised by any one of the qualified financial regulators offers an appropriate, workable and sound legal and regulatory framework.

Eurex Clearing also notes that within the framework of the DMTAA, the possibility exists for CCPs that are regulated in their home countries comparably to the requirements of the Core Principles that apply to Derivatives Clearing Organizations to be able to offer their services in the United States as a multi-lateral clearing organization. We urge the Committee to permit Eurex Clearing (once its status has been recognized by the Commission) and the other MCOs that have already received recognition as such from the CFTC to clear OTC contracts, agreements and transactions not just on excluded commodities but also on exempt commodities. Eurex Clearing supports the application of the additional proposed Core Principles to Derivatives Clearing Organizations and to Foreign Regulated Multi-lateral Clearing Organizations.

In this spirit, I would like to share with you the same thoughts we have expressed to the European Commission. We have strongly supported the Internal Markets Commissioner Charlie McCreevey's call for action to improve market infrastructure for OTC clearing and in particular for credit default swap clearing. We believe that improvements in Europe are of common interest to all market participants because they will also contribute to market stability on a global scale. Furthermore, we believe that there should be an alignment of regulatory policy regarding OTC clearing, first across the Atlantic and then globally. We recognize that that will take time to achieve and that the European regulators believe that decisive action may be appropriate now.

Finally, I note that this is the second time that I have testified before this Committee on behalf of Eurex and Eurex Clearing and we are deeply honored to have been invited back to present our views to this Committee. We very much appreciate the opportunity to discuss these critically important issues with the Committee. I am happy to answer your questions.

Mr. HOLDEN [presiding.] Thank you, Mr. Book.

Mr. Kaswell.

STATEMENT OF STUART J. KASWELL, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, MANAGED FUNDS ASSOCIATION, WASHINGTON, D.C.

Mr. KASWELL. Thank you, Mr. Chairman.

Mr. Chairman, Ranking Member Lucas, and Members of the Committee, I am Stuart Kaswell, Executive Vice President and General Counsel, Managed Funds Association. MFA appreciates the opportunity to testify before you today.

MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds, and managed funds, as well as the industry service providers. MFA appreciates the opportunity to share its views with the Committee regarding the proposed Derivatives Markets Transparency and Accountability Act of 2009.

As participants in our nation's markets, MFA's members share your concerns regarding the challenges in those markets and the difficulties facing our economy. We commend this Committee for considering measures which, in seeking to strengthen the regulatory framework, can help restore stability and confidence in our markets and the economy they serve.

The DMTAA has a number of provisions that MFA generally supports. These provisions would strengthen and codify the information that the CFTC receives to ensure that its decisions are well informed. For example, we support section 4, which would improve reporting of positions of index funds and require the CFTC to issue a rule defining and classifying index traders and swap dealers for data reporting.

We also view sections 9 and 10 of the legislation as useful provisions which should provide the Committee and regulators with greater information about the OTC derivatives markets and international energy commodity markets.

Our members also support the provisions included in section 3, which would codify the CFTC's authority to set conditions on the access of foreign boards of trade to the United States.

While we support these provisions and the Committee's commitment to promoting greater transparency and a more sound regulatory structure, we are concerned about certain other aspects of the legislation.

Section 6 would direct the CFTC to set position limits for all commodities. We believe this provision is unnecessary. The exchanges currently perform this important function and are in a better position to establish and enforce position limits. Moreover, we believe that position limits are more appropriate for the spot month of physical delivered commodities than for the back months of such contracts.

We also view the language in section 11 as problematic, as it; first, effectively mandates that the CFTC set position limits on OTC derivatives; and second, is premature given the lack of understanding about this market. As the Committee knows, section 9 of the bill seeks more detailed information about this market, which we believe is an important predicate before Congress takes further action.

Finally, we believe that section 16, which seeks to eliminate the so-called naked credit default swap transactions, would significantly damage the liquidity and price discovery process in the CDS market. Such an outcome would not only undermine the efficiency of this market, but would also have a negative impact on the real economy as it would increase the cost of capital, and potentially cause the cost of projects and business development to rise substantially.

With respect to section 13, MFA strongly supports moving to a clearing system and a central counterparty for OTC products. In fact, we believe that the credit review and margin requirements attendant to central clearing would address many of the concerns that may have been the motivation for the section 16 language.

While we strongly support central clearing, which has proven to help reduce risks in other commodity and financial markets, we believe that Congress should not mandate this requirement in the OTC market until such platform is fairly mature. Moreover, we believe that over time many OTC products should be standardized and centrally cleared. It would be inadvisable to require all OTC transactions to be centrally settled and cleared since customized products are an important risk management tool.

Mr. Chairman, Ranking Member, although we have outlined certain concerns, MFA and our members are grateful for the opportunity to testify and we appreciate the bipartisan approach you have taken in fashioning this legislation. We appreciate your willingness to consider the views of all interested parties.

We welcome the opportunity to work with you. I do have one request. I would like to add to the record a letter that MFA sent to the Federal Reserve Bank of New York, the SEC and the CFTC to supplement my written statement.

[The prepared statement of Mr. Kaswell follows:]

PREPARED STATEMENT OF STUART J. KASWELL, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, MANAGED FUNDS ASSOCIATION, WASHINGTON, D.C.

Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Committee on Agriculture's hearing on the "Derivatives Markets Transparency and Accountability Act of 2009" (the "Derivatives Act") to be held February 2, 2009. MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and managed futures, as well as industry service providers. MFA's members manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies around the world.

MFA appreciates the opportunity to express its view on the Derivatives Act and the important issues that it raises. MFA members are active participants in the commodities and over-the-counter ("OTC") derivatives markets and have a strong interest in promoting the integrity of these markets. MFA consistently supports coordination between policy makers and market participants in developing solutions to improve the operational infrastructure and efficiency of the OTC credit derivatives markets. We are supportive of the Committee's goals to: (1) enhance transparency and reduce systemic risk; (2) promote a greater understanding of the OTC markets and their interaction with exchange-traded and cleared markets; (3) ensure equivalent regulatory oversight in the international regulatory regime for energy commodities and derivatives and provide for greater information sharing and cooperation among international regulators; and (4) provide additional resources to the Commodity Futures Trading Commission ("CFTC").

Nevertheless, we have significant concerns with several provisions of the Derivatives Act, including, in chronological order, Section 6 "Trading Limits to Prevent Excessive Speculation", Section 11 "Over-the-Counter Authority", Section 12 "Expedited Process", Section 13 "Clearing of Over-the-Counter Transactions", and Section 16 "Limitation on Eligibility to Purchase a Credit Default Swap". We believe these provisions would have the effect of reducing market participants' hedging and risk management tools, and negatively impact our economy by raising the cost of capital and reducing market transparency and efficiency in capital markets. We would like to work with the Committee in addressing these issues. We respectfully offer our suggestions in that regard.

Trading Limits To Prevent Excessive Speculation

As a general matter, greater market liquidity translates into more effective price discovery and risk mitigation, especially in physically-settled contracts. We are concerned that Section 6 "Trading Limits to Prevent Excessive Speculation" will impose upon the CFTC a new obligation that historically has been left to the exchanges in deference to their greater expertise respecting the various factors that affect liquidity in these markets. We are concerned that section 6 implements an overly rigid structure for establishing speculative position limits. We urge that the markets are best served by placing the CFTC in an oversight role.

Currently, the exchanges, as part of their self-regulatory obligations, are involved daily in monitoring the activities of market participants. They frequently engage in soliciting the views of speculators and hedgers in their markets. Also, they are more closely engaged in watching deliverable supply. Because position limits may have an impact on price, we believe speculative position limits are best determined by a regulatory authority, rather than market participants through position limit advisory groups. For these reasons, we believe that the exchanges, subject to their regulatory obligations under the Commodity Exchange Act ("CEA"), should propose the size of the speculative position limits following the processes they now employ with their energy and other markets.

Section 6 would require the CFTC to convene a Position Limit Agricultural Advisory Group and a Position Limit Energy Group, consisting of industry representatives, exchanges and electronic trading facilities, to provide the CFTC with position limit recommendations. While, as stated, we believe the exchanges, subject to the CFTC's oversight, should determine and administer speculative position limits, we are concerned that the make-up of these advisory groups is not well-balanced and therefore does not provide a mechanism for obtaining the views of all parties active in these markets. For example, noncommercial participants add vital liquidity to these markets through investment capital and are necessary to the success of a market. Thus, we believe that each advisory Committee should have the same number of noncommercial participants as there are short and long hedgers.

We support the setting of speculative limits in spot months for physically-delivered energy and agriculture commodities for two reasons. First, physically-delivered futures contracts are more vulnerable to market manipulation in the spot month, because the deliverable supply of the commodity is limited and, thus, more susceptible to price fluctuations caused by abnormally large positions or disorderly trading practices. Second, the commodity is likely delivered by the contract owner during the spot month and has a closer nexus to the end-price received by consumers.

On the other hand, we believe that requiring speculative position limits for all months and for aggregate positions in the energy markets, in particular, has the capacity to distort prices. Commercial hedgers often enter into long-dated energy futures (for example, a contract with an expiration date 7 years into the future) to hedge specific projects. Speculators typically take the other side of these contracts. The markets for contracts in these distant (or back) months are less liquid as there are fewer buyers and sellers for long-dated contracts.

We are concerned that by setting position limits for all months, including the less liquid, back months, the speculative position limit will reduce liquidity in these distant months and distort the market price for these contracts. We note that the

CFTC already has at its disposal several tools, including position reporting and accountability levels, which serve effectively in ensuring market integrity without the inflexibility of speculative position limits.

Cash-settled commodities do not raise the same market manipulation concerns as do physically-delivered commodities in that the ability to impact the futures price by controlling deliverable supply is absent. Cash-settled commodities (particularly financial futures) tend to have deep and liquid markets, are primarily used for hedging and risk mitigation by commercials, do not contribute to price discovery which is usually set in the cash markets and therefore have little or no impact on consumers. The CEA, as amended by the CFTC Reauthorization Act of 2008, provides that any contract that has a significant price discovery function on an exempt commercial market, is subject to greater CFTC regulation and oversight.

We are concerned that imposing speculative position limits on cash-settled commodities will have the effect of depressing liquidity and thereby increase the cost of using these back months. It would appear that Congress has already addressed this issue in section 4a of the CEA which grants to the CFTC broad authority to impose limits on trading and to curb excessive speculation. In MFA's view it would be advisable for all interested parties to work together to address concerns about excessive speculation, rather than having Congress mandate a process that could result in negative consequences. As market participants, we have a strong interest in promoting fair and orderly markets. To this end, we believe the CFTC should be afforded regulatory flexibility, which the current framework provides, in addressing excessive speculation and policing the markets.

Over-the-Counter Authority and Central Clearing

MFA supports the requirement in Section 9 "Review of Over-the-Counter Markets" that the CFTC study and analyze the effects of OTC trading and aggregate limits across the OTC markets, designated contract markets and derivative transaction execution facilities. We applaud this effort in conjunction with the additional authority Congress seeks to provide to the CFTC through Section 4 "Detailed Reporting and Disaggregation of Market Data" and Section 5 "Transparency and Recordkeeping Authorities". We believe these provisions will provide the CFTC with better information to understand the OTC markets and how best to regulate these markets. However, we believe that the CFTC should be authorized to determine position limits under Section 11 "Over-the-Counter Authority" only after the study has defined the existence of risks that are appropriately controlled by the imposition of such limits. In other words, the results of such study should be the predicate for taking further legislative or regulatory action.

We are concerned that section 11 creates a test that can only result in the CFTC concluding that all fungible OTC agreements must be subject to position limits. Section 11 requires the CFTC to determine whether fungible OTC agreements have the *potential* to disrupt market liquidity and price discovery functions, cause severe market disturbance, or prevent prices from reflecting supply and demand. It would be extremely difficult for the CFTC to find that OTC agreements have absolutely no potential for disruption under any circumstances, whether currently known or unknown. Thus, section 11 may be interpreted to automatically provide the CFTC with the authority to impose and enforce position limits for anyone trading in fungible significant price discovery agreements. We recognize that the bill would leave to the CFTC the discretion to use its authority as to the size of the position limits it imposes. Nonetheless, we think the grant of authority is too broad.

With regard to Section 13 "Clearing of Over-the-Counter Transactions", we strongly support the concept of central clearing and believe that it offers many potential market benefits. We greatly appreciate the urgent attention of Federal regulators and Congress in addressing this important matter. The private sector, working in conjunction with the Federal Reserve Bank of New York ("NY Fed"), has made strong progress in standardizing credit default swap ("CDS") contracts and establishing a central clearing house for these contracts. There is also a private sector initiative to develop exchange trading for CDS contracts. As investors in the OTC derivatives markets, we would like to see greater contract standardization and a move toward central clearing for other OTC derivatives instruments, including interest rate, foreign exchange, equity and commodity derivatives.

MFA shares Congress' desire to expedite the establishment of central clearing platforms covering a broad range of OTC derivative instruments. We believe a central clearing platform, if properly established, could provide a number of market benefits, including: (1) the mitigation of systemic risk; (2) the mitigation of counterparty risk and protection of customer collateral; (3) market transparency and operational efficiency; (4) greater liquidity; and (5) clear processes for the determination of a credit event (for CDS). In fact, MFA and its members have been actively involved in the establishment of CDS central clearing platforms.

Congress, regulators, and the private sector should promote central clearing of OTC derivative products. However, while we urge Congress and regulators to stay engaged in the process and development of establishing central clearing platforms for OTC derivatives products, we do not believe that Congress should mandate clearing for all OTC derivatives by a certain date. As a step in this direction, Congress should simplify regulatory procedures and remove obstacles to prompt approval of central clearing for OTC products. For example, in view of the support shown by many spokespeople for different sectors of the agricultural industry, we believe Congress should allow agricultural swaps to be centrally cleared without the need to first obtain an exemption from the CFTC.

Our concern with section 13 mandating central clearing of all OTC derivatives transactions is twofold. First, as central clearing platforms for financial derivatives are still in development, there remain many undetermined and unresolved operational factors that could limit the value of central clearing. Among the operational factors are: most importantly, protection of customer collateral; central counterparty governance and dispute resolution; the most appropriate formats for clearing; and the optimum fee structure.

To the point on protection of customer collateral, we are especially concerned that early discussions on central clearing operations will not protect customer assets through segregated accounts. As noted in our December 23, 2008 letter to the NY Fed, the Securities and Exchange Commission ("SEC") and the CFTC (attached *hereto*), the current collateral management mechanism used by banks do not adequately protect a participant's pledged collateral, and as such, contributes to systemic risk. For example, because pledged collateral at Lehman Brothers was not segregated, once the company was placed in bankruptcy, pledgors became general creditors of the company. With respect to central counterparty governance, we believe a central counterparty should be an established independent body led by a board reflecting balanced representation of all market participants. Similarly, a central counterparty should have an independent, fair and efficient dispute resolution process.

Second, central clearing is not readily attainable for the majority of OTC derivatives because these products are not standardized. We appreciate the Committee's attempt to address the issue of non-standardized, highly unique (individually-negotiated or bespoke) contracts by providing the CFTC with the authority to exempt a transaction from the section 13 clearing requirement. We note that as part of a regulatory framework that maximizes the ability of market participants to mitigate risk and encourage product innovation, it is important to provide market participants with the ability to engage in non-standardized, highly unique contracts. However, in view of the number of OTC derivative contracts that would have to rely on an exemption and the delays that occur when an agency must staff a new mandate, we are concerned that the implementation of section 13 would be highly disruptive to the marketplace.

In contrast to other OTC derivatives, the CDS market has quickly become more standardized for various reasons. When the CDS markets began to develop in 1997, only a few of the major derivatives dealers traded these products. Since these dealers were similarly positioned in the market and traded these contracts as both buyers and sellers, they were able to negotiate and develop standardized templates for CDS contracts. These template contracts, with some modifications, have remained relatively unchanged and are currently used by all market participants that trade CDS. This standardization is a major reason why CDS contracts are highly liquid and attractive products.

Conversely, derivatives dealers are generally the sellers of other OTC derivatives and will negotiate and structure different terms with each counterparty. As a result, other OTC derivatives are not as fungible or liquid as CDS. The fungibility and liquidity of CDS contracts have caused them to reach a certain level of standardization and efficiency, which have made them ripe for centralized clearing. The same can be said for certain interest rate, energy and agricultural commodity derivatives.

By way of comparison, the majority of OTC derivatives markets, including those trading interest rate, foreign exchange, and equity derivatives, are nowhere near the level of standardization of the CDS markets. The CDS markets account for roughly 8% to 9% of the notional volume of the OTC derivatives market. As stated above, these other OTC derivative instruments are not interchangeable between buyers and sellers, and are generally sold by banks or dealers to market participants other than banks or dealers.

MFA fully supports collaborative industry-wide efforts and partnerships with regulators, like the NY Fed, SEC and CFTC to develop solutions to promote sound practices and to strengthen the operational infrastructure and efficiency in OTC derivatives trading. MFA is an active participant in the Operations Management Group (the "OMG"), an industry group working towards improving the operational infrastructure and efficiency of the OTC derivatives markets. The goals of the OMG are:

- Full global use of central counterparty processing and clearing to significantly reduce counterparty credit risk and outstanding net notional positions;
- Continued elimination of economically redundant trades through trade compression;
- Electronic processing of eligible trades to enhance T+0 confirmation issuance and execution;
- Elimination of material confirmation backlogs;
- Risk mitigation for paper trades;
- Streamlined trade lifecycle management to process events (*e.g.,* Credit Events, Succession Events) between upstream trading and confirmation platforms and downstream settlement and clearing systems; and
- Central settlement for eligible transactions to reduce manual payment processing and reconciliation.

In recent years, the OMG and other industry-led initiatives have made notable progress in the OTC derivatives space. Some of the more recent market improvements and systemic risk mitigants have included: (1) the reduction by 80% of backlogs of outstanding CDS confirmations since 2005; (2) the establishment of electronic processes to approve and confirm CDS novations; (3) the establishment of a trade information repository to document and record confirmed CDS trades; (4) the establishment of a successful auction-based mechanism actively employed in 14 credit events including Fannie Mae, Freddie Mac and Lehman Brothers, allowing for cash settlement; and (5) the reduction of 74% of backlogs of outstanding equity derivative confirmations since 2006 and 53% of backlogs in interest rate derivative confirmations since 2006.

MFA supports the principles behind section 13, but, as discussed, has concerns with how these principles will be implemented. Although central clearing is not appropriate for *all* OTC derivative contracts, we firmly believe that greater standardization of OTC derivative contracts and central clearing of these more standardized products would bring significant market benefits. Indeed, we believe that central clearing offers substantially greater opportunity to address concerns about systemic risk, than other alternatives, such as section 16 of the legislation. To this end, MFA is committed to continuing its collaboration with the major derivatives dealers and service providers to prioritize future standardization efforts across OTC derivatives and other financial products. MFA also understands Congress's desire to have greater oversight of these markets and believes there is an important role for the NY Fed, CFTC and SEC to play in monitoring and guiding industry-led OTC derivatives solutions. We believe it would be more appropriate at this stage to require the applicable regulatory authorities to work with market participants towards the principles espoused in section 13 and to provide the Committee with frequent progress reports.

Expedited Process

Section 12 "Expedited Process" provides the CFTC with the authority to use emergency and expedited procedures. While we do not object to this authority, we strongly urge Congress and the CFTC to use the notice and comment process whenever possible. We believe the notice and comment process is more likely to protect the public interest, minimize market disruptions and unintended consequences, and result in better regulation.

Limitation on Eligibility To Purchase a Credit Default Swap

Credit derivatives are an important risk transfer and management tool. Market participants use credit derivatives for hedging and investment purposes. We believe both are legitimate uses of the instrument and are equally important components of a liquid and well-functioning market.

Section 16 would make it a violation of the CEA for a market participant to enter into a CDS unless it has a direct exposure to financial loss should the referenced credit event occur. We appreciate that it is the goal of the provision to add stability to the CDS market by reducing excess speculation. Nonetheless, this provision would severely cripple the CDS market by making investment capital illegal and removing liquidity providers. Without investment capital in the market, market participants wishing to hedge their position through a CDS would find few, if any, market participants to take the other side of the contract. As a result, the CDS market could cease functioning for lack of matching buyers and sellers. Market participants that risk their own capital provide depth and liquidity to any market, and the market for CDS is no exception. Because the provision would eliminate such market participants, the CDS market would have much less price transparency and continuity.

This outcome is particularly troubling given the benefits the CDS markets provide to the capital markets and to the overall economy. CDS contracts have improved our capital markets by enhancing risk transparency, price discovery and risk transferal, with the effect of reducing the cost of borrowing. Market participants use the CDS market as a metric for evaluating real-time, market-based estimates of a company's credit risk and financial health; and it is in this way that the CDS markets provide risk transparency and price discovery. Market participants find that CDS market indicators are a superior alternative to relying on credit rating agency scores.

CDS contracts also provide banks, dealers and other market participants with a tool to mitigate or manage risk by dispersing credit risk and reducing systemic risk associated with credit concentrations in major institutions. Take the following scenario, which section 16 would prohibit, for example:

Bank A owns a $1 billion loan to Company X. Bank B owns a $1 billion loan to Company Y. Both banks would be better off from a risk management perspective, assuming that Companies X and Y have comparable credit worthiness, if they each had a $500 million Company X loan and a $500 million Company Y loan. The loans, however, are not transferable. Through CDS contracts, Bank A is able to buy Company X protection and sell Company Y protection, and Bank B is able to do the opposite. In this way, market participants use CDS contracts to manage risk. Financial markets benefit overall from the reduction in systemic risk.

Accordingly, these products reduce an issuer's cost of borrowing from banks, dealers and other market participants by enabling these entities to relay existing risk and/or purchase risk insurance against a particular issuer. Simply put, CDS markets facilitate greater lending and support corporate and public finance projects. By reducing the depth and liquidity of the CDS market, the cost of capital would rise. As a consequence, new investment in manufacturing facilities and other private sector projects and public works efforts would be more expensive.

If market participants could not hedge their market risk through CDS contracts, the risk premium on debt would increase significantly. We do not believe this is advisable, especially in light of the troubled state of the U.S. economy and the Congress' current stimulus package deliberations. To our knowledge, Congress has never before imposed a trading restriction such as is proposed in section 16 on any type of commodity or financial instrument, and for good reason. Congress has previously recognized in section 3 of the CEA that we have a national public interest in providing a means for managing and assuming price risks, discovering prices or disseminating price information. Shutting out investors from the CDS market would be contrary to the public policy interests enumerated in the Act. As noted below, we believe that there are more effective alternatives for addressing concerns about the CDS markets.

All Commodities Are Not Equal

Finally, we are concerned with the expansion of the bill to all commodities. Physically-delivered, cash-settled and OTC commodities each trade in distinct markets and have different characteristics. We believe the rationale behind certain requirements, such as spot month speculative limits and aggregate position limits, are not applicable to financial futures or their OTC derivatives. Legislation that attempts to regulate all commodity and financial markets in an identical manner will fail to take into consideration the different needs of these markets and important functions they serve. Specifically, we refer to sections 6, 11 and 13, which we believe attempts to uniformly regulate these distinct markets. Moreover, such legislation will risk affecting liquidity and the opportunity for innovation that have made these markets so widely used and integral to the economy.

Conclusion

As Congress, including this Committee, considers ways to restore stability and confidence to our markets and to address the recent economic downturn, we believe it is important to recognize the important role the OTC derivatives markets have played. These products allow market participants to contribute vital market liquidity, mitigate risk, support lending and project finance, and facilitate economic growth.

In considering ways to promote enhanced risk management and greater transparency in the marketplace, we urge you to resist any efforts which, while well-intended, could prove harmful to these important markets and our broader economy. These markets have played a pivotal role with respect to the development of our financial markets and the growth of our nation's economy. This success is attributable to the innovation and sophistication of our financial markets and the participants of these markets. It is also a testament to the competency of the underlying regulatory framework.

MFA would like to thank the Committee for allowing us the opportunity to share our views on these important issues. MFA, and our members, are committed to working constructively with this Committee, the Congress, and the Administration over the coming weeks and months as this legislation and the broader dialogue regarding financial regulatory reform progresses.

Thank you.

ATTACHMENT

December 23, 2008

TIMOTHY F. GEITHNER, *President,* Federal Reserve Bank of New York;	Hon. CHRISTOPHER COX, *Chairman,* U.S. Securities and Exchange Commission;	Hon. WALTER LUKKEN, *Acting Chairman,* U.S. Commodity Futures Trading Commission.

Dear President Geithner, Chairman Cox and Chairman Lukken:

Recently, Managed Funds Association ("MFA")[1] and its members met with the Federal Reserve Bank of New York (the "NYFRB") to discuss and provide comments regarding the state of the credit default swap ("CDS") market, including our feedback on current proposals to establish a central clearing counterparty for the CDS market. As part of our ongoing commitment to proactively work with regulators on topics that pose significant market or systemic risk concerns, we wish to direct your attention to the protection and safeguarding of customers' initial margin that they deposit with dealer financial institutions in connection with the trading of all over-the-counter ("OTC") derivatives.

Effects of Current Collateral Management Practices

By way of background, the default of Lehman Brothers, a major OTC derivatives counterparty, and the resulting market concerns about the viability of other major dealers, has caused significant volatility in the capital markets. These concerns demonstrate that current mechanisms for collateral management, outside of the context of broker-dealer accounts covered by Exchange Act Rule 15c3–3, do not adequately protect the pledgors of collateral and can contribute to systemic risk in several important respects:

- The purpose of initial margin is to provide dealers with a cushion against the potential counterparty risk they assume when entering into an OTC derivatives contract with a customer. However, since such margin is not typically segregated from the dealers' other unsecured assets, what is supposed to be a credit mitigant for the dealer instead subjects the customer to actual credit risk on the posted amounts.
- If a dealer becomes insolvent, initial margin posted by customers that is not so segregated is treated in bankruptcy as a general unsecured claim of the customer. As a result, customers who are counterparties to that dealer stand to incur significant losses, regardless of the current value of their derivatives contracts.
- Investment managers have fiduciary duties to their investors. When a dealer experiences difficulties, the risk to initial margin may cause managers to seek to hedge counterparty exposure to such dealer (either through the CDS market or by trying to close-out or assign derivatives trades away from such dealer). These hedging actions can have a further destabilizing impact on such dealer and the market generally, thereby increasing systemic risk.

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York. For more information, please visit: *www.managedfunds.org.*

- In addition, given that dealers are able to freely use posted collateral, they have come to rely on initial margin, a fluctuating source of cash, to fund their business activities. As trades are closed-out or assigned, dealers are required to return initial margin to their customers. The return of margin constricts dealers' liquidity and, as recent events demonstrate, the inability of the dealers to access cash has potentially severe market consequences.

We highlight that the aforementioned counterparty risks related to customer initial margin have been greatly exacerbated over the last few months as dealers as a whole have significantly increased their demands for initial margin. These risks are in turn further compounded by the general weakening of the financial sector as a whole.

Enhanced Customer Segregated Accounts

As you are aware, the segregation of initial margin is a key component of the central clearingparty initiatives for the CDS market, and we understand that the NYFRB, SEC and CFfC have stipulated this condition to be a prerequisite for regulatory approval. We agree that segregation of initial margin is crucial to the success of these clearing initiatives, but also believe that the protection of customer initial margin should be implemented more broadly for all OTC derivatives, irrespective of the launch of any CDS central counterparty because it is critical in order to promote broader market stability and to mitigate counterparty risk. Protection of customer initial margin with respect to all bilaterally negotiated OTC derivatives could be incorporated into the existing transaction structure through dealer use of a segregated account, in the name of, and held for the benefit of, the customer (*e.g.,* at a U.S. depository institution or a regulated U.S. broker-dealer), whereby the dealer would not be permitted to rehypothecate the initial margin held in such an account. This would promote broader market stability and mitigate counterparty risk.

Given that dealers will be required to provide initial margin segregation as part of the clearing initiatives, they should be capable of offering this to customers on a broader basis. However, to date the dealer community, as a whole, has been resistant to such efforts by MFA's members and other investment managers.

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We recognize the efforts of regulators to collaborate on mitigating risk and promoting market stability. We appreciate the constructive working relationship fostered by each of you as well as the opportunity to share the views of our members on this important topic. We welcome the opportunity to discuss this issue further with each of your staffs. If we can provide further information on this topic, or be of further assistance, please do not hesitate to contact us at [Redacted].

Yours Sincerely,

RICHARD H. BAKER,
President and Chief Executive Officer.

cc:
Hon. BEN BERNANKE,
Chairman,
Board of Governors, Federal Reserve System;

PATRICK M. PARKINSON,
Deputy Director,
Division of Research and Statistics, Board of the Federal Reserve System;

ANANDA RADHAKRISHNAN,
Director,
Division of Clearing and Intermediary Oversight, Commodity Futures Trading Commission;

THEODORE LUBKE,
Senior Vice President,
Bank Supervision Group, Federal Reserve Bank of New York;

ERIK R. SIRRI,
Director,
Division of Trading and Markets, U.S. Securities and Exchange Commission.

Mr. HOLDEN. Without objection.

Mr. Rosen.

STATEMENT OF EDWARD J. ROSEN, J.D., PARTNER, CLEARY GOTTLIEB STEEN & HAMILTON LLP, NEW YORK, NY; ON BEHALF OF SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Mr. ROSEN. Thank you, Mr. Chairman. I should clarify I am here today representing SIFMA, the Securities Industry and Financial Markets Association.

SIFMA commends the Committee for its attention to the integrity of the U.S. markets and the leadership role that this Committee in particular has played over the years in addressing these issues. There is undoubtedly a need for regulatory——

The CHAIRMAN. Could you pull the microphone a little closer?

Mr. ROSEN.—including reform that will relate to OTC derivatives. Measures are needed to improve regulatory transparency particularly to ensure appropriate capital oversight of professional intermediaries and OTC derivatives whose activities, as we have seen, can have systemic consequences.

We look forward to working with this Committee and Congress on broad regulatory reform to address these issues. However, we are deeply concerned that the draft bill could have profound, *albeit* unintended, adverse consequences not merely for American markets, but for many mainstream American companies. This would contribute to the forces that are driving the current credit crisis.

SIFMA's testimony describes the extraordinary extent to which mainstream American companies depend on CDS and other OTC derivatives to manage their risks and obtain access to financing. Direct and indirect limitations on access to these products will increase the risks to which these companies are subject, and in turn increase the risks of loss to which they are subject, the volatility of their earnings, their cost of funds, and thereby reduce their share prices and impair their competitiveness. A number of provisions in the draft bill raise these concerns.

The proposed prohibition on purchasing so-called naked CDS protection would essentially eliminate the corporate CDS market. We can think of no traded product that is subject to a restriction of this kind, yet every financial product can be equally used for hedging or to express a positive or negative market view. It is precisely the interaction of these market views that is the essence of price discovery and efficient markets. As a result of this, CDS would become extremely expensive and illiquid in the sense of financial guarantee insurance or a product whose limitations the credit default swap market was specifically developed to address.

American companies, including companies in the agricultural sector, would have reduced access to financing, and available financing costs would increase. Bank revenues from lending activity would also be reduced, placing further pressure on the financial strength of the banking sector, which currently depends heavily on public funds.

Mandating the clearing of all OTC derivatives with a narrow exception for contracts that are both highly illiquid and highly customized is understandable but impractical, and we think unnecessary. Not all OTC derivatives can be cleared. As this Committee has heard, clearinghouses must be able to obtain reliable current pricing and historical data in order to calculate the appropriate collateral requirements and to model the clearinghouse risk. Also, not all companies have the operational infrastructure to participate.

But rather than mandating clearing, we believe it would be far more effective for a prudential supervisor to have authority over all systemically significant market participants, including the authority to require clearing where it is appropriate and/or impose capital charges for the incremental risks represented by uncleared positions. We think this would be an important element in any comprehensive regulatory reform.

With regard to carbon offsets, we believe it is clear that off-exchange markets compliment exchange markets. They serve as incubators for developing products, and they enable derivatives to be tailored to companies' risk management needs. Prohibiting them in the case of environmental derivatives will, in our view, only impede the development of a market that is a national priority.

Provisions of the bill would impose indirect and potentially direct position limits on OTC derivatives. In our view, off-exchange physical positions have a far greater ability to influence commodity pricing and disrupt markets than purely notional financially settled contracts. In the absence of a perceived need to impose limits on the size of OTC physical positions, we don't see the justification for limits on notional exposures.

The restrictive definition of *bona fide* hedging in the proposed bill would effectively impose a *de facto* position limit on OTC derivatives that are hedged on futures exchanges. However, the proposed position limit exception for swap dealers does not reflect the way in which companies manage their risk, or the manner in which swap dealers intermediate client risk. The result could be to curtail corporate access to OTC derivatives even for highly desirable risk management purposes.

The draft bill also does not recognize that many index and other strategies are not speculative in nature, and would curtail the use of important strategies that are effectively market-neutral and stabilizing, and preclude fiduciaries from protecting retirees and others investing for retirement from protecting their retirement income from erosion due to high rates of inflation.

Commercial interests are inherently directionally biased market participants and have the greatest capacity to influence prices and markets. All or virtually all the CFTC energy manipulation cases brought over the last 5 years have involved commercial energy traders. By decreasing the prevalence of directionally neutral participants and increasing the relative dominance of commercial interests, SIFMA is concerned that the draft bill would make the U.S. futures markets far more susceptible than they are today to manipulation. At a minimum, it will increase spreads and the cost of hedging for commercial interests.

[The prepared statement of Mr. Rosen follows:]

PREPARED STATEMENT OF EDWARD J. ROSEN, J.D., PARTNER, CLEARY GOTTLIEB STEEN & HAMILTON LLP, NEW YORK, NY; ON BEHALF OF SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Introduction

Chairman Peterson, Ranking Member Lucas, and Members of the Committee:

My name is Edward Rosen[1] and I am appearing today on behalf of the Securities Industry and Financial Markets Association (SIFMA).[2] We thank you for the invitation to testify today on the Committee's draft legislation, entitled "Derivatives Markets Transparency and Accountability Act of 2009".[3] My testimony today reflects the views of SIFMA member firms active in both the listed and over-the-counter (OTC) derivatives markets in the United States and abroad.

Overview

Preservation of the integrity of U.S. markets must be a paramount concern for the public sector and the private sector alike. SIFMA thus appreciates the Committee's current attention to this objective and commends the Committee for the ongoing leadership role that it has played over many years in sponsoring measures necessary to ensure the integrity of U.S. derivatives markets.

SIFMA wholeheartedly endorses a number of the central themes that underpin the draft bill. Specifically, we agree that:

- *Regulatory Transparency.* Effective regulatory oversight of commodity markets requires appropriate regulatory transparency that ensures timely CFTC access to relevant position information;
- *OTC Clearing.* The clearance of OTC derivatives can and, we think, will play an important role in mitigating operational and counterparty risks for large segments of the OTC derivatives markets and, where appropriate, should be given a high priority by supervisors and the private sector;
- *Speculative Limits.* Limits on the size of speculative positions can play an important role in preserving orderly markets; and
- *Global, Linked Markets.* Listed derivatives, OTC derivatives and physical commodity markets are global and inextricably linked.

We commend the draft bill's focus on these themes.

Nonetheless, SIFMA and its members are deeply concerned by a number of provisions in the draft bill. We believe these provisions do not represent the most effective solutions to current market issues. Instead, we believe these provisions would have profound adverse consequences not merely for OTC and listed derivatives markets, but also for mainstream American companies. Specifically, key provisions in the draft bill would:

- Prohibit the purchase of uncovered CDS protection;
- Require the clearing of all OTC derivatives, subject to limited exceptions;
- Authorize the imposition of position limits for OTC derivatives;
- Prohibit off-exchange trading in futures on carbon credits and emission allowances; and
- Eliminate position limit exemptions for risk management strategies.

We believe these provisions would:

- Deepen the current crisis by fundamentally undermining both the efficacy and availability of listed and OTC derivatives as risk management tools for large and small American businesses, thereby increasing costs, risks and earnings volatility for such companies throughout the economy; the draft bill's CDS-related provisions in particular would significantly and adversely impact access to, and the cost of, financing for American companies, which could lead to continued job losses;
- Increase (and not decrease) the susceptibility of commodity markets to manipulation and disorderly trading and enhance the ability of commercial traders with a vested interest in commodity prices to influence such prices;

[1] Mr. Rosen is a partner in the law firm Cleary Gottlieb Steen & Hamilton LLP, testifying on behalf of and representing the views of SIFMA and not those of Cleary Gottlieb Steen & Hamilton LLP.

[2] SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C. and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at *http://www.sifma.org*).

[3] Draft dated January 28, 2009 (1:08 p.m.).

- Impede successful development of cap and trade programs by prohibiting non-exchange derivatives on carbon offsets and emission allowances;
- Preclude pensioners, retirees and those saving for retirement from protecting the real dollar value of their retirement income against erosion from the effects of commodity price inflation through the use of commodity derivatives; and
- Drive the development outside the United States of markets in energy and other core commodities and financial products that are key to the U.S. economy, with the result that, while these markets would have the ability to inform or drive U.S. prices for the affected commodities and products, the U.S. Congress would have no ability to influence these markets.

We believe the potential consequences of these provisions run directly counter to the Committee's own well-intentioned objectives. They also run counter to the efforts of Congress and the supervisory community to address the credit crisis and, if enacted, would almost certainly exacerbate the crisis.

SIFMA understands that there is a need for regulatory reform and that such reform will need to address issues such as regulatory transparency and prudential oversight with respect to OTC derivatives. However, SIFMA strongly believes that any statutory changes in the regulation of OTC derivatives, particularly changes that would have such far-reaching consequences as those proposed in the draft bill, should only be undertaken in the context of broader regulatory reform and should focus on decreasing risk and improving transparency and efficiency in the OTC derivatives markets, while maintaining the significant benefits these markets currently provide for mainstream American companies and institutional investors.

It is estimated that more than 90% of the 500 largest companies in the world use OTC derivatives.[4] An even greater percentage (94%) of the American companies in this group use OTC derivatives. More than half of medium-sized American companies are estimated by Greenwich Associates to use OTC derivatives.[5] These companies rely on access to OTC derivatives for important risk management purposes (some of which may, but many of which will not, fall within the draft bill's proposed definition of *bona fide* hedging).

Mainstream American companies in every sector of the U.S. economy, including within the agricultural sector, depend on access to efficiently priced financing in order to make capital investments, purchase inventory and equipment, hire employees and otherwise fund their businesses. The availability of a robust corporate CDS market is essential if lenders are to meet the demand for these borrowings and to be in a position to do so on an efficiently-priced basis.

CDS and other OTC derivatives thus not only play an important market function, they also play a critical role in enabling ordinary companies, outside the financial sector, to manage the risks of their businesses and to obtain the financing necessary to expand, and in many cases to sustain, their businesses. And, as the statistics cited above indicate, significantly more than half of the U.S. economy would be directly and adversely affected by the inability of professional intermediaries to make these products available and to utilize them themselves.

Against this background and, particularly in the context of the current crisis, it is all the more important that Congress adopt legislative initiatives that preserve the benefits of these products, and access to these products, while carefully targeting those measures that are appropriate to protect the public interest.

Our comments with respect to specific provisions of the draft bill are summarized in the following section.

Section-by-Section Comments

Prohibition of "Naked" CDS (Section 16)

Section 16 of the draft bill would prohibit the purchase of CDS protection by any person who does not have direct exposure to financial loss should the referenced credit events occur. Very simply, the proposed prohibition would effectively eliminate the corporate CDS market.

Although CDS are a relatively recent financial innovation, they have quickly become the most important tool available to banks and institutional investors, such as pension funds, for managing the credit risks arising from commercial loans and corporate bond investments. CDS, which are typically fully collateralized, are the only liquid financial instruments that enable a company exposed to a third party's default risk to manage that credit risk in an efficiently priced market. As such, CDS

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[4] International Swaps and Derivatives Association, Inc., 2003 Derivatives Usage Survey, *http://www.isda.org/statistics/*.

[5] Greenwich Associates, *http://www.greenwich.com.*

enable lenders to hedge the credit risks inherent in corporate financing that are essential to economic growth, and, in turn, reduce the cost of funds for borrowers. CDS also free up additional credit capacity, which enables banks to expand credit facilities available to their corporate clients.

In addition, CDS provide important benefits for other market participants as well. For example, asset managers and other institutional investors use CDS as a liquid instrument through which to obtain credit exposure to particular companies and to adjust their credit exposures quickly and at a lower cost than alternative investment instruments. In addition, many market participants use CDS pricing to provide a more accurate valuation of credit risk than would otherwise be possible by looking solely to less liquid cash markets.

No traded product is subject to a restriction similar to the one proposed to be imposed on CDS by the draft bill. This is not surprising given that the proposal would strictly limit CDS to hedging transactions and would significantly restrict the involvement of professional intermediaries and investors in these products.

As a policy matter, the purchase of uncovered CDS protection is no different than buying or selling futures, options, stocks or bonds because the relevant product is perceived to be undervalued or overvalued by the market. These investment activities are critical to liquidity, reduced execution costs and efficient price discovery in these markets and all involve legitimate and, indeed, desirable investment activities.

Absent the participation of intermediaries and non-hedgers, CDS would cease to trade in a market, and they would become extremely illiquid and costly—both to enter into and to terminate.[6] As a direct result, lenders and investors would be left with far more limited and more expensive alternatives for managing the credit risks arising from their lending and investment activities. In turn, American companies, including those in the agricultural sector, would have significantly reduced access to financing, and the financing that would be available would be more costly. Bank revenues from lending activity would also be reduced, placing further pressure on the financial strength of the banking sector.

The impact of these effects on the credit crisis, and efforts to reverse the credit crisis, are plain.

The OTC derivatives markets in general, and the corporate CDS market in particular, have performed extremely well and have remained liquid throughout the current market turmoil, providing important benefits not only for financial market participants but also for large numbers of mainstream American companies. The corporate CDS market in particular has provided a critical price discovery function for the credit markets, which have otherwise become extraordinarily illiquid during the crisis and, as a result, provide extremely little credit market price discovery apart from corporate CDS. Measures that would interfere with this function would be highly undesirable and would further exacerbate the credit crisis.

The segment of the CDS market in which extremely significant losses have been incurred involved the writing of CDS protection on mortgage-related asset-backed securities; in many ways, a very different product than corporate CDS. The market for CDS on asset-backed securities is also a relatively small segment of the overall CDS market; generally less than 2% of the aggregate CDS market.[7] Losses in this segment led, in part, to the rescue of the AIG insurance conglomerate and the failure or near failure of many monoline financial guarantee insurers subject to oversight by state insurance supervisors. The losses incurred through these products did not result, however, from flaws in the products; in fact, the products transferred the risk of the referenced asset-backed securities as intended by the parties. These losses were directly related to the unexpectedly large losses in the subprime mortgage sector and the leveraging of these exposures through highly structured securities, such as mortgage-related collateralized debt obligations (CDOs—not to be confused with CDS). A number of capital market participants incurred significant losses in the subprime mortgage-related CDS and CDO market.

Although some CDS market participants have incurred large losses in connection with corporate CDS, for example, in the case of CDS referencing financial institutions such as Lehman Brothers, the corporate CDS market nonetheless functioned well as a result of effective bilateral mark-to-market collateral arrangements. The private sector's initiative to establish a clearinghouse for CDS will further reinforce the salutary and stabilizing effects of appropriate bilateral collateral arrangements.

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[6] The proposed requirement could also subject CDS to regulation as a form of financial guarantee insurance, thereby subjecting providers of protection to the additional burdens and inefficiencies of regulation by insurance supervisors in each of the 50 states.

[6] DTCC Deriv/SERV Trade Information Warehouse Reports (data as of the week ending January 23, 2009), *http://www.dtcc.com/products/derivserv/data/index.php.*

The measures proposed in the draft bill would do little to address the regulatory issues actually presented by the failures and near failures resulting from these events; and we see nothing in the events of the recent past that would justify a response in the form of the effective elimination of corporate CDS.

Mandatory Clearing of OTC Derivatives (Section 13)

Section 13 of the draft bill would require the clearing of all OTC derivatives, subject to a very limited exemptive process in the case of products that are infrequently transacted, highly customized, do not serve a price discovery function and are entered into by parties able to demonstrate their financial integrity.

The clearing of OTC derivatives transactions has the potential to provide many important benefits, including the mitigation of operational and counterparty risks and facilitation of regulatory oversight, and should be encouraged where appropriate. However, section 13 of the draft bill would mandate that all OTC derivative contracts must be cleared, including not only CDS but also other OTC derivatives such as interest rate and currency swaps, the markets for which are also significant and have performed well throughout the current credit crisis, with an extremely narrow exception for certain infrequently traded and highly customized contracts. Such a clearing requirement is unworkable as a practical matter and would adversely affect mainstream American companies and reinforce conditions contributing to the current credit crisis.

As a threshold matter, not all OTC derivatives contracts are suitable for clearing or can be cleared without presenting unacceptable risk management challenges for a clearinghouse, and not all market participants can participate in a clearing system. In order to mitigate its counterparty risk, a clearinghouse must determine the aggregate risk to which it is exposed as a result of its clearing activities and must collect mark-to-market margin, in cash or liquid securities such as U.S. Treasury securities, every day from each of its members with respect to such members' positions in the clearinghouse. In order to do this, the clearinghouse must be able to model the risks associated with the products it clears and must be able to determine the amount of the market-to-market margin it is to pay or collect each day, a process that requires access to price data. The administrative and financing demands of participating in a clearinghouse on members are significant, and as a practical matter, mainstream American companies that are end users would not participate because they do not have the personnel, operational infrastructure and expertise, nor the cash and securities on hand, to do so. As evidence of this, although exchange-traded interest rate and currency futures are widely available, mainstream American companies are negligible users of such products.

Reliable risk modeling requires statistically robust historical price data sets for each cleared product. Reliable mark-to-market margining, in turn, requires (1) products that are both completely standardized and sufficiently liquid (one or the other of these characteristics is not sufficient) and (2) ready access to reliable price sources. Even where these conditions are present, existing clearinghouses must have developed an approved risk modeling approach in order for market participants to clear their positions without subjecting themselves or the clearinghouse to inappropriate market and counterparty risks.

Against this background, it is clear that a regulatory model that requires market participants to obtain a prior exemption based on highly subjective criteria before they transact would be utterly unworkable, would inject unnecessary legal uncertainty (potentially subjecting transactions to after-the-fact legal challenges), would interfere with the execution of risk management transactions and would impede new product development. Further, as noted above, limitations on the availability of CDS would directly and adversely affect American companies.

While measures to promote standardization can afford risk-reducing benefits, there are many circumstances in which customized solutions will be more appropriate. For example, standardization of products effectively precludes the application of hedge accounting by American companies, as standardization vitiates the ability to structure customized hedges that comply with the requirements of Financial Accounting Standard 133. Without hedge accounting, American companies who do choose to use derivatives would experience significant volatility in their reported earnings, for reasons altogether unrelated to their core businesses. The potential for such volatility in reported earnings would result in less hedging and more risks being borne by companies who are ill-equipped to manage them.

Moreover, the proposed provision is unnecessary and exemplifies the pitfalls of addressing the regulation of OTC derivatives outside of an appropriate comprehensive regulatory framework. As a practical matter, the major OTC derivatives intermediaries (at least in financial derivatives) are subject to supervision by Federal regulators, including the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System, as national banks, Federal Reserve System member banks or members of bank (or financial) holding company groups. These supervisors have plenary authority to identify those circumstances in which clearing is appropriate and to require such clearing and/or impose capital charges that address any incremental risks that are associated with transactions not so cleared. Indeed, the industry has been working with the Federal Reserve since 2005 on various voluntary initiatives to reduce risk and improve the infrastructure of the CDS market, including the development of a CDS clearinghouse. We believe a model under which these issues are addressed by a direct prudential supervisor of all systemically significant participants in the OTC derivatives markets is a far more effective approach than, and one that would avoid the significant pitfalls of, a more rigid statutory mandate such as the one included in the draft bill.

Imposition of Position Limits on OTC Derivatives (Section 11)

Section 11 of the draft bill would authorize the CFTC to impose position limits on "speculative" OTC transactions that are fungible with exchange-traded futures. The potential limitation on the scope of permitted OTC derivatives exposures as contemplated by section 11 of the draft bill would have potentially profound ramifications. The potentially adverse implications of such limits for mainstream American companies are significantly exacerbated by the draft bill's proposed categorization of risk management transactions as "speculative." (See the immediately following discussion of section 6 of the draft bill.)

The CFTC and the futures exchanges have been able to ensure orderly futures markets through, among other measures, limitations on speculative futures positions without having to limit, for example, off-exchange positions in fungible (*i.e.,* deliverable) physical commodities. It is plain that large physical positions on either side of the market have a far greater potential to disrupt futures markets than do purely notional, financially-settled OTC derivatives. In the absence of such limitations on physical positions, or any perceived need for such limitations, we question the need to impose such limits on purely notional, financially-settled OTC derivatives positions. As noted above, any such proposal for direct and restrictive regulation of OTC derivatives would, in any event, be more appropriately considered in the context of broader regulatory reform.

Elimination of Risk Management Exemption (Section 6)

Section 6 of the draft bill would limit the availability of position limit exemptions for risk management positions other than those held by commercial entities directly engaged in a physical merchandising chain under a highly restrictive definition of *bona fide* hedging.

The policy rationale for position limit exemptions has historically been based on the inference that a trader who is directionally neutral with respect to the price of a commodity underlying its futures position lacks the motivation to engage in abusive price manipulation. Thus, hedging, arbitrage and spread trading were early examples of cases in which such exemptions were available. As portfolio theory evolved, and financial futures and OTC derivatives became prevalent, a variety of risk management strategies became the basis for similar exemptions.

The draft bill would reject this policy rationale and would arbitrarily subject broad ranges of financial hedging and risk management activity to the limitations applicable to truly speculative positions. SIFMA believes that these limitations would have a profound adverse impact on futures and OTC derivatives markets, on retirees and investors, and on companies seeking to manage the commercial and financial risks to which they are subject.

These adverse effects are all the more troubling in light of the absence of any rigorous analysis of empirical data indicating that the involvement of noncommercial entities in the futures markets has caused the recent volatility in energy and other commodity prices. Indeed, the only rigorous analysis to date of relevant empirical data by the CFTC has reached precisely the opposite conclusion.

Swap dealers and mainstream American companies.

Section 6 of the draft bill would severely restrict the ability of swap dealers to provide customized OTC derivatives hedges to commercial end users and corporations. In most cases, swap dealers use a portfolio approach under which they manage price risk using combinations of physical transactions, OTC financially-settled transactions and exchange-traded futures. Thus, when entering into an OTC swap transaction with a counterparty, the dealer does not necessarily hedge that specific transaction with a specific offsetting transaction in the U.S. futures markets or the OTC derivatives markets. Rather than hedge the price risk created by a specific OTC transaction, the dealer might use the U.S. futures markets or the OTC derivatives markets to hedge the net exposure created by multiple transactions conducted contemporaneously or even at another point in time.

Known as "warehousing risk", a dealer may also enter into numerous or long-dated OTC transactions with a client that is seeking to hedge its price risk. At the time of entering into the transactions, it may not be prudent or possible for the dealer to enter into offsetting transactions in the futures markets or with other OTC dealers. Thus, in warehousing risk, the dealer assumes the price risk from its client and manages it in its trading book using the portfolio approach described above.

By requiring that dealers, in order to qualify for the hedge exemption from speculative position limits, be able to demonstrate that any given position in the futures or OTC derivatives markets (hedged by futures) serves as a hedge against a specific OTC transaction with a counterparty that is itself hedging price risk, the draft bill would prohibit useful and risk-reducing hedging, which clearly runs counter to the public policy goals of the draft bill, and would significantly limit dealers' ability to effectively intermediate the risks of their end user and corporate clients which, in turn, would likely significantly reduce liquidity in the futures and OTC derivatives markets, increase hedging costs and leave the markets far more susceptible than they are today to undue influence by commercial interests that have a stake in directional price movements. It would also increase hedging costs for mainstream American companies, leaving them more susceptible to price risk and less competitive.

Index strategies.

The draft bill's proposed speculative position limit provisions would limit futures trading that is not, in fact, speculative and that does not have a market impact analogous to speculative trading, and, in turn, could potentially interfere with commodity price formation to the detriment of the markets.

As an example, pension plans and other investment vehicles hold portfolios whose "real dollar" value is eroded by inflation. Investment of a targeted allocation of the portfolio in a broad-based commodity index can effectively "hedge" that risk financially. Such a strategy, like "*bona fide*" physical hedging, is undertaken for risk management and risk reduction purposes, is passive in nature (*i.e.,* positions are bought in accordance with the index algorithm and asset allocations and are generally held, not actively traded) and is not speculative in purpose or effect. The strategy does not base trading decisions on expectations as to whether prices will go up or down—the strategy is generally indifferent as to whether prices go up or down. The strategy generally leads to trading in the opposite direction of speculators, offsetting their impact: when commodity index levels rise, portfolio allocations to index strategies are reduced (resulting in selling), when commodity index prices fall, allocations to index strategies are increased (resulting in buying). Over the long term, the strategy acts as a stabilizing influence for commodity prices.

These trends were found by the CFTC in its recent study to be consistent with its analysis of relevant trading data. On the other hand, we are unaware of a rigorous analysis of empirical trading data that supports the correlations that have been alleged between index trading and increasing commodity prices. In addition, investing on a formulaic basis in a broad-based commodity index would be the least effective means of "manipulating" the market for an individual commodity.

Increased susceptibility to manipulation.

By restricting the hedge exemption to commercial entities, the draft bill would, in effect, significantly increase the relative market share of these entities and simultaneously reduce liquidity, by reducing the sizes of positions of traders employing risk management strategies that are truly market neutral. Any proposed legislation on this topic must take into account three basic facts. First, although a commercial user's futures position may be offset by a physical position, commercial entities are almost never price neutral. Second, the category of market participant that is best positioned to influence market prices are commercial users controlling large physical positions. Third, significantly increasing the relevant market share of commercial entities increases the ability of such traders to influence prices.

As a result, SIFMA believes that the draft bill would make the U.S. futures markets far more susceptible than they currently are to price manipulation by commercial traders with directional biases. Indeed, nearly all of the CFTC energy manipulation cases that have been brought over the last 5 years have been brought against traders at firms that would be considered commercial entities under the draft bill.

Carbon Offset Credits and Emission Allowances (Section 14)

Section 14 would establish an exchange monopoly for the trading of futures on carbon offset credit and emission allowances and criminalize off-exchange trading in such products.

The most successful, liquid and efficient markets are those in which trading is permitted both on-exchange and off-exchange. Indeed, exchange markets are generally enhanced by the success of related off-exchange markets. Off-exchange trading is also essential for a number of reasons. Off-exchange markets serve as the incubators through which trading terms are able to coalesce around agreed market conventions that promote liquidity and efficiency. This process facilitates the evolution of standardized and liquid products that can be effectively exchange traded. Off-exchange trading also enables derivatives to be tailored to the risk management needs and circumstances of individual companies. Off-exchange trading also facilitates the cost-effective execution of large wholesale transactions for which an exchange environment can be inefficient. Finally, the proposed prohibition would eliminate the fundamental salutary market benefits of inter-market competition—a cornerstone of efficient markets and American capitalism.

As a result, we believe the proposed prohibition would impair market efficiency and impede innovation and the successful development of these products. As a direct consequence of these effects, the proposed provisions would, in our view, undermine rather than promote the important national policy objective of encouraging the development of successful and efficient trading markets in these important products.

OTC Reporting Requirements (Section 5)

Section 5 of the draft bill would require the CFTC to impose detailed reporting requirements with respect to OTC derivatives. We note that the CFTC currently has the authority to ascertain information regarding the OTC derivatives positions of large traders holding reportable positions in related futures contracts.

SIFMA urges the Committee to avoid the creation of an ongoing detailed reporting regime applicable to OTC derivatives generally, as such a regime has the potential to result in large amounts of, but disproportionately little useful, information, imposing significant costs and burdens on the resources of the private sector and the CFTC alike. SIFMA would not, however, be opposed to a carefully tailored reporting regime (similar to that currently employed by the CFTC) under which the CFTC may require firms to provide upon request targeted information regarding large positions in OTC derivatives that are fungible with exchange-traded futures contracts (or significant price discovery contracts) that are under review by the CFTC as part of its market surveillance function or in connection with any investigation.

Reporting Entity Classification (Section 4)

Section 4 of the draft bill addresses the classification and disaggregation of large position data and would require disaggregation and reporting of positions of swap dealers and index traders. SIFMA supports the classification of position data into categories that promote the market surveillance function of the CFTC. The distinction between market participants who have directionally biased positions and those that are directionally neutral is a key one in this context. On the other hand, since swap dealers and index traders may fall into either of these categories, it is not clear that the proposed disaggregation would promote the CFTC's surveillance function.

Foreign Boards of Trade (Section 3)

Section 3 of the draft bill would require the CFTC to impose specific rule mandates on foreign boards of trade. Recognizing that our markets are global and inextricably linked, international coordination and harmonization are important objectives. However, these objectives can be better accomplished without the prescriptive imposition of U.S. rules on foreign markets. In addition to potentially curtailing U.S. access to foreign markets, any such approach would likely be regarded as imperious and may well invite retaliatory measures that could compromise the ability of U.S. exchanges to compete for international business—currently an important growth segment of U.S. exchange markets.

Conclusion

OTC derivatives markets play a key role in the functioning of the American economy by helping companies, lenders and investors to manage risk and arrange financing. With the limited exception noted above involving the writing of CDS protection on mortgage-related asset-backed securities by AIG and monoline financial guarantee insurers, the OTC markets have performed well and remained liquid throughout the current market turmoil, providing important benefits for a large number and wide range of companies.

It must be recognized that the consequences of many of the proposed provisions in the draft bill would not fall solely or even most heavily on the professional intermediaries participating in these markets. Instead, the consequences of these provisions would, if enacted, harm very large numbers of mainstream American companies whose financial strength is critical to the welfare and recovery of our national economy.

As noted above, many American companies use OTC derivatives to hedge their cost of borrowing or the operating risks of their businesses. Many of those who do business overseas use OTC derivatives to hedge their foreign exchange exposures. Many companies also hedge their commodity and other price exposures. For many companies, the availability of efficiently priced access to financing and other products depends on access by their counterparties to OTC derivatives such as CDS and interest rate and currency swaps. By limiting or eliminating access to basic risk management tools that American companies routinely use in the day-to-day management of their businesses, the draft bill could have a potentially profound negative impact on these companies and our nation's economic recovery.

Recognizing the importance of OTC derivatives, we continue to support efforts to address the risks and further improve the transparency and efficiency of the OTC derivatives markets. Similarly, recognizing the importance of efficient and orderly exchange markets we continue to support tailored measures to improve the efficiency and integrity of listed futures markets. We look forward to working with this Committee, Congress and regulators on initiatives designed to improve oversight of OTC derivatives, while maintaining the significant benefits the OTC derivatives markets currently provide, and to promote orderly and efficient exchange markets.

The CHAIRMAN [presiding.] Thank you very much, Mr. Rosen.

Mr. Weisenborn. Welcome to the Committee.

STATEMENT OF BRENT M. WEISENBORN, CEO, AGORA-X, LLC, PARKVILLE, MO

Mr. WEISENBORN. Thank you.

Mr. Chairman, Ranking Member Lucas and Members of the Committee, thank you for the opportunity to share my views on the important questions of OTC commodity market regulation that you are now considering. Before addressing the substance of my testimony, let me place my views in context by saying a few words about Agora-X and my background.

Agora-X is a development stage company located in Parkville, Missouri. It is dedicated to bringing efficiency, liquidity and transparency to the over-the-counter commodity markets by means of advanced, regulatory compliant electronic platforms for OTC transaction. Agora-X was founded by FCStone, a commodities firm headquartered in Kansas City. Agora-X is now also partially owned by NASDAQ OMX. I have been a member of both the Chicago Board of Trade and the Kansas City Board of Trade. I also have self-regulatory experience of the NASDR, now renamed FINRA.

OTC markets play an important role in market innovation. They provide an alternative venue for contract formation, price discovery and risk mitigation. For institutional participants, these markets can provide substantial public benefit if they are required to be transparent, reportable, clearable, and to function within the bounds of an electronic platform.

Well-organized OTC markets can dramatically improve efficiency of commodity markets. By doing so, OTC markets can reduce the cost that consumers ultimately pay for commodities. When the markets are transparent, liquid and open, transaction costs fall and spreads contract. In transparent markets, there is much less room for manipulation.

With broad, transparent OTC markets, the likelihood of devastating speculative bubbles is significantly reduced. Thus, well-regulated OTC markets can contribute to the integrity of U.S. financial markets as a whole. Of course, we must not ignore the lessons taught by the current crisis, but we should be careful to identify the true nature of these problems. In my view, the major problems have been in the misuse of certain commodity contracts and have not been in the means by which they are traded.

This brings me to the major point I wish to make. I urge the Committee to preserve the existing OTC commodity markets, but to modify the existing law to improve them. The present financial crisis has demonstrated the need to reform to the OTC commodity markets. Clearly these markets can be improved by means of mandatory reporting, clearing, and by moving these markets to transparent electronic facilities.

In addition, an important issue for this Committee is the treatment of OTC contracts on agricultural commodities. Contracts on agricultural commodities deserve the same treatment as contracts on non-ag commodities. Existing law and regulation discriminate against these commodities by making it difficult or impossible to create OTC agricultural contracts electronically, or to clear them. These restrictions, which do not advance any regulatory goal, make no sense today. An example may help to illustrate my point.

Last summer, grain prices in the United States reached a very high level, but many producers who wanted to lock in those prices with cash-forward contracts were unable to do so. The country elevators who ordinarily offer such contracts could not do so because they could not finance the margin required for offsetting future positions. I think clearable, structured OTC contracts could have emerged to bridge that gap if it were not for the restrictive regulations.

We currently face a time when agricultural markets desperately need liquidity. Allowing cleared, structured OTC contracts can help facilitate and accelerate liquidity. With the safeguards this Committee will add to protect the OTC markets, it is time for eligible agricultural commodity producers, processors, and users to have full access to the OTC markets.

I think four things are essential to the OTC commodity markets' reform agenda.

First, all physical commodities, including agricultural commodities, should be treated equally.

Second, OTC commodity markets should be transparent and reportable to the CFTC.

Third, OTC markets should be clearable and less narrow. CFTC-crafted exemptions should apply.

Fourth, all OTC contracts should be established on or reported to an electronic facility.

Accordingly, I generally support the language of the draft bill, but propose that it be improved to allow a quality of treatment of agricultural commodities, establish electronic documentation and audit trail, trading and clearing requirements, and to give CFTC authority to craft exemptions. Finally, the bill should appropriately define and authorize electronic trading facilities.

Thank you for giving me the opportunity to share my views on the draft bill.

[The prepared statement of Mr. Weisenborn follows:]

PREPARED STATEMENT OF BRENT M. WEISENBORN, CEO, AGORA-X, LLC, PARKVILLE, MO

Mr. Chairman and Members of the Committee,

My name is Brent Weisenborn of Parkville, Missouri. I am CEO of Agora-X, LLC. Thank you for the opportunity to share my views on the important questions of regulation of the OTC commodities markets that you are now considering in the proposed bill (draft bill) to amend the Commodity Exchange Act (CEA).

(1) Background.

Agora-X, LLC is a development stage company that is dedicated to bringing efficiency, liquidity and transparency to over-the-counter (OTC) commodity markets by means of state of the art, regulatory compliant, electronic platforms for OTC contract negotiation as well as trading and transaction execution. Its initial focus is on cash-settled OTC contracts related to physical commodities, such as energy and agricultural commodities.

Agora-X, LLC was founded in 2007 by FCStone Group, Inc, which is a commodities firm with deep roots in agricultural commodities markets. FCStone originated as a regional cooperative in the Midwest offering traditional hedging services to cooperative grain elevators, and has grown to offer commodity trading and price risk management services throughout the nation and beyond. In addition to FCStone, Agora-X is now also partly owned by The NASDAQ OMX Group, Inc.

I am tremendously excited about the opportunity that exists to improve the functioning of the commodities markets by means of innovations such as the electronic platforms offered by my company and by adjustments to existing regulatory systems that you are now considering.

I feel qualified to comment on these points, not only because of my role with Agora-X, but also because of years of experience in both the securities and commodities markets.

I have been a member of both the Chicago Board of Trade (CBOT) and the Kansas City Board of Trade (KCBT). I traded futures and was an option market maker as a proprietary trader. I served on the Board of Directors of the KCBT from 1996 to 1998.

I was a founder and served from 1987 until 2001 as President of Security Investment Company of Kansas City, an institutional only Broker-Dealer and NASDAQ Market Maker. Security Investment Company specialized in proprietary trading and wholesale market making.

I was elected to the NASDR (renamed FINRA), District No. 4 District Committee in 1998 and was elected Chairman in 1999. I served as Chairman until January of 2001 and as co-Chairman of the District 4 & 8 (Chicago) Regional Committee. The NASDR (FINRA) District No. 4 covers seven states: Missouri, Kansas, Iowa, Nebraska, North Dakota, South Dakota and Minnesota. At that time I was responsible for the regulatory oversight of approximately 55,000 stockbrokers in 2,500 offices. I also served on the NASDR National Advisory Council for the year 2000. In June of 2000, I was elected to the NASDR National Small Firm Advisory Board.

As a result of my experience I have observed at close hand the evolution of the electronic markets for securities, and I see strong parallels with electronic markets for commodities that are just now emerging.

(2) Need for Regulatory Change.

OTC markets play an important role of market innovation. They provide an alternative venue of contract formation, price discovery and risk mitigation outside the rigid and restrictive regulatory framework for “designated contract markets” that applies to commodity exchanges. OTC markets can provide substantial public benefit without creating systemic risk of the kind that precipitated last September’s financial crisis if they are required to be transparent, reportable, clearable, and to function within the bounds of electronic communication networks (ECNs) or exempt commercial markets (ECMs).

Well organized OTC markets also dramatically improve efficiency of commodity markets and by doing so OTC markets reduce the costs that consumers ultimately pay for commodities. When the markets are transparent, liquid and open, the spreads that swaps dealers can charge shrink and as a result, transaction costs fall. Efficient markets also inevitably attract liquidity and become broader. If these markets become clearable, they will also bring increased liquidity to clearing houses and registered commodity exchanges.

In addition, in open markets there is much less room for manipulation and the possibility of committing fraud. Because of the transparency and breadth of these markets, the likelihood of devastating speculative bubbles is also significantly reduced. These markets will help bring interests of traders and sound market fundamentals into balance. Thus, well regulated and well managed OTC markets will contribute to the integrity of U.S. financial markets as a whole.

Of course, we must not ignore the problems that have emerged from the current crisis, but we should be careful in identifying the sources of these problems. In my view, the major problems have been in the misuse of securities and commodities contracts, and have not been in the means by which they are traded.

This brings me to the major point I wish to make. I urge the Committee to preserve the OTC commodity markets, but to modify the existing law to derive improvements in them.

The present financial crisis demonstrated that there are inefficiencies in the regulation and functioning of the OTC commodities markets and that these markets can be improved by means of electronic audit trail and reporting, by clearing and by moving these markets to a transparent ECN or ECM facilities, where possible.

In addition, an important issue for this Committee is the treatment of OTC contracts on agricultural commodities. We believe that agricultural derivatives, such as commodity swaps and options, deserve the same treatment as the non-agricultural commodities under the draft bill. Existing law and regulation discriminate against these commodities by making it difficult or impossible to create OTC agricultural contracts electronically or to clear them. Harmonization of regulation for OTC contracts on agricultural commodities with other contracts will provide the same public benefits to agricultural commodities as are available to all other commodities. In addition it will eliminate existing regulatory anomalies such as prohibitions of clearing and electronic trading that arose in the evolution of the OTC markets and were discarded over time for other commodities, but retained without critical analysis for agricultural commodities.

An example may help illustrate the point. Last summer grain prices in the United States reached very high levels, but many producers who wanted to lock in those prices with cash forward contracts were unable to do so because the country elevators who ordinarily offer such contracts did not do so because of inability to finance the margin required for offsetting futures positions. I think clearable, structured OTC contracts could have emerged to bridge that gap if it were not for restrictive regulations.

We currently face a time when agriculture desperately needs liquidity. The agricultural OTC market is a significant existing market that is developing entirely outside of registered commodity exchanges. Allowing cleared, structured agricultural OTC contracts on ECNs can help facilitate and accelerate liquidity, while adding transparency and efficiency.

With the safeguards that this Committee will add to protect the OTC markets it is time for agricultural commodity producers, processors and users to have full access to such regulated markets.

(3) Conclusions and Recommendations.

During the last few decades the securities markets have been truly revolutionized by innovative electronic trading methods. Now, the commodities markets are following the same path of innovation. Based on my experience I think four things are essential to the OTC commodity markets reform agenda:

(A) The OTC commodity markets should be retained, but improved;

(B) Unless exempted by the CFTC, all OTC commodity contracts, agreements and transactions must be reportable to the CFTC;

(C) Unless exempted by the CFTC, all OTC commodity contracts, agreements and transactions must be clearable; and

(D) Unless exempted by the CFTC, all OTC commodity contracts, agreements and transactions must be negotiated on an electronic communication network (ECN) via the request for quote process (RFQ) or traded or executed algorithmically on an exempt commercial market (ECM) or posted by means of give-ups to such electronic trade reporting facilities.

Accordingly, I generally support the language of the draft bill, but propose amending the draft bill as follows:

1. ***Clearing of all OTC commodity contracts, agreements and transactions.*** Repeal existing laws and regulations which prohibit electronic trading and clearing of OTC contracts on agricultural commodities and provide that agricultural commodities should be given equal regulatory treatment with non-agricultural commodities by amending section 2(g) of the CEA. The draft bill implies some of this, but it should be further clarified to assure that agricultural commodities fully benefit from the reforms enacted.

2. ***Electronic Documentation.*** Require that all OTC commodity contracts, agreements and transactions be electronically documented, whether or not cleared, to assure transparency and to facilitate the reporting of these transactions.

3. ***Negotiation, Trading and Execution on ECNs or ECMs.*** Require that unless certain limited CFTC-defined exemptions and exclusions apply, all OTC commodity contracts, agreements and transactions be negotiated, traded and executed on an ECN or ECM or posted by means of the give-ups to such electronic facilities.

4. ***Definition of ECN.*** The definition of "Trading Facility" in the CEA should be amended to explicitly not include the ECNs. A new definition of the ECN should be drafted and added to the CEA.

Thank you for giving me the opportunity to share my views on the draft bill. I look forward to offering any assistance with drafting this proposed legislation as you may request.

BRENT M. WEISENBORN,
CEO, Agora-X, LLC.
[Redacted]

cc:
RICHARD A. MALM, ESQ.,
Dickinson, Mackaman, Tyler & Hagen, P.C.,
[Redacted];

PETER Y. MALYSHEV, ESQ.,
McDermott, Will & Emery, LLP.,
[Redacted].

The CHAIRMAN. Thank you very much, Mr. Weisenborn, for your testimony.

Mr. Fewer, welcome to the Committee.

STATEMENT OF DONALD P. FEWER, SENIOR MANAGING DIRECTOR, STANDARD CREDIT GROUP, LLC, NEW YORK, NY

Mr. FEWER. Thank you, Mr. Chairman.

Chairman Peterson, Ranking Member Lucas and Members of the Committee, my name is Donald Fewer, Senior Managing Director of the Standard Credit Group, LLC in New York. As the first interdealer broker in the over-the-counter CDS market, I consummated the first trades between dealers at the market's inception in 1996, and have participated in the market's growth and development since then, including single named CDS, credit index and index tranches. I have submitted my full statement for the record and will comment on four areas in the proposed legislation.

The first is regarding central counterparty clearing. My first point is an affirmation of the sentiments expressed by virtually all of the panelists that central clearing facilities of organized exchanges will work to eliminate counterparty credit issues in over-the-counter bilateral derivative contracts, and will undergird and strengthen the over-the-counter derivatives market infrastructure.

Providing access to all market participants, sell-side and buy-side, to an open platform centered in CCP, will stimulate credit market liquidity by reconnecting more channels of capital to the credit intermediation and distribution function. The use of exchange CCP facilities will have a significant impact on credit markets by enabling participants to free up posted collateral and recycled trading capital back into market liquidity.

Legislation that expands the role of organized exchanges beyond CCP to include exchange execution of OTC credit derivative products will be disruptive, and lacks the clear recognition of the already well-established and economically viable over-the-counter market principles.

My second point is exchange execution of over-the-counter credit derivative products. Given the size and established structure of the OTC derivatives market, migration toward exchange execution has been, and will be, minimal apart from mandatory legislative action. It has been argued that the lack of standard product specifications of OTC derivatives is a market flaw and should be remedied by mandated exchange listing and execution.

This argument lacks support. CDS contracts utilize standard payments and maturity dates. Credit derivative participants have adopted a higher degree of standardization because credit risk is different from the other types of underlying risks. Unlike interest rate swaps in which the various risks of a customized transaction can be isolated and offset in underlying money and currency markets, credit default swaps involve lumpy credit risks that do not lend themselves to decomposition. Standardization, the most significant attribute of exchange-traded products, is therefore a substitute for decomposition.

Recent improvements in CDS market standards have resulted in up-front payments, and the establishment of annual payments that resemble fixed coupons similar to bonds. These changes will simplify trading and reduce large gaps between cash flows that can amplify losses. Most importantly, enhancing these standards will build a higher degree of integration between CDS and the underlying over-the-counter cash debt markets that simply cannot be replicated on an exchange. This aggregation and dispersion of credit risk between the over-the-counter cash and derivative markets is critical to the development of overall debt market liquidity, going forward.

Other mechanisms implemented by the OTC market include post-default recovery rate auction and trade settlement protocols, innovation and portfolio compression methodologies. All of these functions performed exceptionally well during the market turbulence of last year. A regulation that would force exchange execution of CDS products would be harmful and disruptive to the credit risk transfer market.

The third point I would like to address is underlying bond ownership requirements as proposed by the legislation. The draft legislation fails to recognize the underlying risk transfer facility of the plain vanilla credit default swap by requiring bond ownership. Limiting CDS trading to underlying asset ownership will cripple credit markets by stripping from the instrument the risk management and credit risk transfer efficiencies inherent in its design. The basic use of a credit default swap enables a credit intermediary, such as a commercial bank, to trade and transfer credit risk concentrations while being protected from a default at the senior unsecured level of the reference entity's capital structure.

For example, financial institutions servicing large corporate clients must offer commercial lending, corporate bond underwriting, working capital facilities and interest rate risk management. In addition, the financial institution provides a market-making facility in all of the secondary markets for which it underwrites a client's credit. All of these financial services expose the financial institution to client counterparty risk.

The credit risk transfer market optimizes the use of capital by enabling financial intermediaries to efficiently hedge and manage on- and off-balance-sheet credit risk. Credit derivatives therefore play a vital role to credit intermediation and market liquidity. Requiring bond ownership will counteract and work directly against the credit stimulation initiatives in the economic stimulus legislation currently under consideration.

My fourth and final point is the unintended consequences of inappropriate regulatory action. As I detailed in my full statement, the value of cash bond trading has declined dramatically since the implementation of FINRA's Trade Reporting and Compliance Engine known as TRACE. TRACE led directly to the deterioration of the over-the-counter inter-dealer, investment-grade, and high-yield bond trading volume.

While TRACE was anticipated to facilitate transparency, its implementation revealed the failure to fully understand over-the-counter corporate bond market structure, and created an inadvertent level of disclosure that frankly devastated the economic basis for dealer market-making. The lack of a liquid secondary market for corporate debt throughout the term structure of credit spreads dramatically increased the risk in underwriting new debt. The underwriters and dealers facility to trade out of and manage bond risk was so restricted that the unintended consequence was to damage the secondary bond market.

It is not coincidental that the U.S. high-yield bond market reported zero new-deal issuance for the month of November in 2008. Almost half of the U.S. companies fell below investment-grade credit ratings, making the $750 billion high-yield bond market a critical source of financing.

Mr. Chairman, Mr. Ranking Member and Members, I appreciate the opportunity to provide the testimony today and would urge you to continue to reach out to the inter-dealer market for its input.

[The prepared statement of Mr. Fewer follows:]

PREPARED STATEMENT OF DONALD P. FEWER, SENIOR MANAGING DIRECTOR, STANDARD CREDIT GROUP, LLC, NEW YORK, NY

Mr. Chairman Peterson, Ranking Member Lucas and Members of the Committee:

Good morning. My name is Donald P. Fewer, Senior Managing Director of Standard Credit Group, LLC. a registered broker/dealer and leading provider of execution and analytical services to the global over-the-counter inter-dealer market for credit cash and derivative products. I was fortunate enough to have consummated the first trades between dealers at the markets inception in 1996 and have participated in the market's precipitous growth and development as well as its challenges. I would like to thank this Committee for the opportunity to share my thoughts on the draft legislation on Derivatives Markets Transparency and Accountability Act 2009, as it applies to the over-the-counter market generally and the credit derivatives market specifically.

The Committee's draft legislation comes at a pivotal time. The consequences of the crisis paralyzing global credit markets will have significant and long term effects on credit creation, intermediation and risk transfer. I believe that legislation that attempts to address derivative market accountability and transparency should reflect a clear understanding of credit market dynamics, particularly credit risk transfer. With this in mind, I would like to address five areas of the draft legislation that does not meet this pre-requisite:

- Central Counterparty Clearing and the Role of Organized Exchanges.

- Exchange Execution of OTC Credit Derivative Products.
- Transparency and Price Discovery.
- Underlying Bond Ownership Requirements of CDS.
- Unintended Consequences of Inappropriate Regulatory Action.

Central Counterparty Clearing, Credit Risk Transfer Derivatives and the Role of Organized Exchanges

There has been significant criticism of the over-the-counter derivative products market, particularly credit derivatives, as the root cause of our global crisis. While much disparagement is based upon misinformation and misunderstanding, effective regulation directed at supporting the proper functioning of the credit risk transfer market is critical. Use of central clearing facilities of organized exchanges will not only work to eliminate counterparty credit issues in OTC bilateral derivative contracts, it will undergird and strengthen the OTC derivatives market infrastructure. The role of organized exchanges, in providing CCP services, can be the mechanism by which new capital and liquidity providers participate in the credit risk transfer market. The use of CCPs by all market participants, including "end-users" (*i.e.,* hedge funds, asset managers, private equity groups, insurance companies, *etc.*) should be encouraged by providing open and fair access to key infrastructure components including but not limited to exchange clearing facilities, private broker trading venues and contract repositories. OTC trading venues will provide voice and electronic pre-trade transparency, trade execution and post-trade automation. This view of providing access to all market participants, sell side and buy side, to an open platform centered in CCP, will stimulate credit market liquidity by re-connecting more channels of capital to the credit intermediation and distribution function. The use of exchange CCP facilities will have a significant effect by enabling participants to free up posted collateral and recycle trading capital back into market liquidity.

However, the proposed legislation, which expands the role of organized exchanges beyond CCP to include exchange execution of OTC credit derivative products, will be disruptive and lacks a clear recognition of the already well established and economically viable OTC market principles.

Exchange Execution of OTC Credit Derivative Products: Disruptive and Unnecessary

Given the size and establishment of the OTC derivatives market, migration toward exchange execution has been and will be minimal apart from mandatory legislative action. With regard to CDS, the failure to migrate to exchange execution is because the credit derivatives market is characterized with a higher degree of standardization than other forms of OTC derivatives. *It has been argued that the lack of standard product specifications of OTC derivatives is a market flaw and should be remedied by mandated exchange listing and execution.* This argument is inaccurate. CDS contracts utilize standard payments and maturity dates. Credit derivatives participants have adopted a higher degree of standardization because credit risk is different from other types of underlying risks. Unlike interest rate swaps, in which the various risks of a customized transaction can be isolated and offset in underlying money and currency markets, credit default swaps involve "lumpy" credit risks that do not lend themselves to decomposition. Standardization, the most significant attribute of exchange traded products, is therefore a substitute for decomposition. Recent work on reinforcing CDS market standards will result in upfront payments and the establishment of annual payments that will resemble fixed coupons. These changes will simplify trading and reduce large gaps between cash flows that can amplify losses. Most importantly, enhancing these standards will build a higher degree of integration between CDS and underlying OTC "cash" debt markets that cannot be replicated on an exchange. This aggregation and dispersion of credit risk between OTC cash and derivative markets will be critical to the development of overall debt market liquidity going forward. Other mechanisms implemented by the OTC market include post-default recovery rate auction and trade settlement protocols, novation and portfolio compression methodologies. All of these functions performed exceptionally well during the market turbulence of last year. A regulation that would force exchange execution of CDS products would be harmful and disruptive to the credit risk transfer market.

It has also been argued that the "opaqueness" of the OTC derivatives market is a detriment to market transparency and price discovery and exchange listing and execution is required to increase the integrity and fairness of the market place. With respect, this position does not reflect current market realities.

Transparency, Execution and Post-Trade Automation: The Work of OTC Markets

The over-the-counter market has a well established system of price discovery and pre-trade market transparency that includes markets such as U.S. Treasuries, U.S. Repo, EM sovereign debt, *etc.* OTC markets have been enhanced by higher utilization of electronic platform execution. Private broker platforms will interface directly to CCPs and provide automated post-trade services. This was clearly demonstrated in the wake of Enron's collapse and the utilization of CCP facilities by the leading over-the-counter energy derivatives brokers to facilitate trading and liquidity. It is clear to all market participants that financial dislocation and illiquidity will persist across many asset classes and geographies for some time. As alluded to earlier, the unique nature of the OTC market's price discovery process is absolutely essential to the development of orderly trade flow and liquidity in fixed income credit markets. We are entering a period with an abundance of mispriced securities where professional market information and execution is required. OTC price discovery throughout the term structure of credit spreads will require a more focused and integrated execution capability between OTC CDS and cash, utilizing key component inputs from equity markets and the various constituents of the capital structure (*i.e.,* senior and subordinated corporate bonds, loans, *etc.*). This type of exhaustive price discovery service can only be realized in the over-the-counter market via execution platforms that integrate derivatives and cash markets across asset classes (*i.e.,* debt, equities, emerging markets, *etc.*). This will be critical to the repair of credit market liquidity globally.

The implementation of a central trade repository, (*i.e.,* DTCC), that is publicly disseminating detailed information of the size, reference entity and product breakdown of the credit derivatives market on a weekly basis will serve to strengthen public confidence in disclosure and transparency of the CDS market.

Underlying Bond Ownership Requirements: The Virtual Elimination of the Inherent Value of CDS

The draft legislation fails to recognize the underlying risk transfer facility of the "plain vanilla" credit default swap by requiring bond ownership for credit default swap purchases. Limiting CDS trading to underlying asset ownership will cripple credit markets by stripping from the instrument the risk management and credit risk transfer efficiencies inherent in its design. The basic use of a credit default swap enables a credit intermediary (*i.e.,* commercial bank) to trade and transfer credit risk concentrations while being protected from an event of default at the senior unsecured level of the reference entities capital structure. For example, a financial institution servicing a large corporate client is required to offer commercial lending, corporate bond underwriting, working capital facilities, interest rate management services, *etc.* In addition, the financial institution provides a market-making facility in all of the secondary markets for which it underwrites a client's credit (*i.e.,* senior, junior and convertible bonds, loans, *etc.*) All of these above services expose the financial institution to counterparty risk to the corporate customer. The credit risk transfer market optimizes the use of capital by enabling financial intermediaries to efficiently hedge and manage on and off balance sheet (*i.e.,* unexpected credit line draw-downs, "pipeline" risk, *etc.*) credit risk. Credit derivatives therefore play a critical and vital role to credit intermediation and market liquidity. *The implementation of the use of CDS in requiring bond ownership will counteract and work directly against the credit stimulation initiatives currently under consideration by Congress in the Economic Stimulus Bill H.R. 1.*

Unintended Consequences of Inappropriate Regulatory Action

TRACE—an example of disruptive regulatory action

Goldman Sachs recently reported that the value of cash bond trading has fallen each year over year for the past 5 years. The value of cash bond trading stood at $12,151bn in 2003 and declined to $8,097bn in 2008. The CDS market achieved CAGR exceeding 100% since 2004 and stood at $62tn year end 2007. The inter-dealer market experienced firsthand the decline in secondary market bond turnover and that decline can be correlated directly to the implementation of **FINRA's Trade Reporting and Compliance Engine (TRACE)** reporting system. TRACE led directly, as an unintended consequence, to the deterioration of OTC inter-dealer investment grade and high yield bond trading volume. While TRACE was anticipated to facilitate the demand for "transparency" its implementation revealed the lack of depth in understanding the OTC corporate bond market structure and created an inadvertent level of disclosure that devastated the economic basis for dealer "market-making". The lack of a liquid secondary market for corporate debt throughout the term structure of credit spreads dramatically reduces the risk tolerance to underwrite new debt. The underwriters and dealers' facility to trade out of and manage bond risk was so restricted that the unintended consequence was to damage the secondary bond market. This is most notable in the U.S. High Yield bond market. *It is not coincidental that the U.S. High Yield bond market reported **zero** new deal issuance for the month of November 2008.* Almost half of U.S. companies have below-investment grade credit ratings, making the $750 billion junk-bond market a critical, if not sole source of financing for an increasing number of corporations large and small all across America.

Loss of Money and Capital Markets to Off-Shore Financial Centers

The United States is at significant risk to lose the flow of money and capital market trading activities to off-shore financial centers more conducive to over-the-counter market development. While American financial institutions have been the originators of financial innovation that enabled the free flow of capital across international markets, the United States is declining as a recognized financial capital globally. Legislation that creates a regulatory environment that prohibits capital market formation will push market innovation and development to foreign markets, which would be welcoming.

Mr. Chairman, Mr. Ranking Member and Members of the Committee, I appreciate the opportunity to provide this testimony today and would urge that you continue to reach out to the dealer market for its input. I am pleased to respond to any questions you may have. Thank you.

The CHAIRMAN. Thank you, Mr. Fewer.

Mr. Weisenborn, in the recommendations section of your testimony, you said that all the OTC contracts should be reportable, electronically documented unless exempted. What do you think about the statutory standards in the draft for exemptions, and would you change any of them?

Mr. WEISENBORN. Well, I would leave most of it to the CFTC to determine exemptions. They have years of experience in this area, and I would yield to their expertise. Generally, we agree with the language as it is currently constructed.

The CHAIRMAN. Okay. Mr. Kaswell maintains that the majority of the OTC derivative contracts are nowhere near the level of the standardization of CDS markets.

To Mr. Book and Mr. Weisenborn, do you agree with that statement? Is most of the volume in the OTC world too nonstandard for clearing?

Mr. BOOK. If I may comment on that, Mr. Chairman, the limits for central clearing when the products have not sufficiently cleared need to come to a daily settlement price, and also the clearinghouses are not in a position to dispose of their positions in case of a default. Especially for structured products with little liquidity, it will be difficult for a clearinghouse to provide central clearing services. As mentioned in the testimony, for those products there should then be the review with CFTC if they provide sufficient economic benefit for hedging.

Mr. WEISENBORN. We feel that clearing is next to godliness, so in all circumstances we would encourage that all products would be cleared. In the cases where they are simply not standard enough to clear, we would urge the Committee to consider requiring those transactions to be reported electronically so that there is an electronic audit trail and a window of transparency for the regulator to see those transactions.

The CHAIRMAN. That seems to make sense. Is that feasible? Is the electronic platform there to require that?

Mr. WEISENBORN. Yes, sir. This is the same evolution that occurred 10 years ago in the equity markets with our OTC market at the time. When I was on the Board of the NASDR we owned NASDAQ, and we had to bring in some rules to encourage or to mandate electronic audit trail and trade reporting. This software, Agora, is simply that. It is a piece of software that allows for electronic trading, audit trail, and electronic delivery. We have agreements with both NYMEX and CME. We use those as our DCO to clear our transactions. So this is probably the third generation of this software. It is quite feasible, sir.

The CHAIRMAN. There are other people that have this software too, I assume?

Mr. WEISENBORN. Yes, sir. This is the first application that we are aware of in this asset class.

The CHAIRMAN. Nobody else is electronically trading in this area?

Mr. WEISENBORN. To this point in the OTC commodity space, because of the prohibitions, we are a development-stage company. We have not begun trading. Our software is complete, and that is why we are here to urge a level playing field for agricultural commodities, so that they can be cleared and traded electronically. But from what we know, this would be the first application of ECN technology, such as BATS and some of the other things that have developed in Kansas City in this asset class.

The CHAIRMAN. Mr. Kaswell, you are highly critical of setting the position limits, speculative position limits for all contracts. If we have limits and they have worked in the agricultural markets, why wouldn't it be appropriate to have them for all other markets of physical commodities?

Mr. KASWELL. Thank you for the question, Mr. Chairman. We appreciate the importance of having an effective regulatory system, and appreciate the opportunity to make what we hope are useful suggestions in that regard.

We think that with regard to the exchange rate of products, that the exchanges are closer to that market and therefore would be in a better position to make those assessments. We think they have done a good job. That is why we feel that the proposal in this statute is not optimal.

The CHAIRMAN. So because you are going to do the right things?

Mr. KASWELL. I am sorry, sir. I am having trouble hearing you.

The CHAIRMAN. I said because you are in a position to do the right thing better than we are?

Mr. KASWELL. I don't think I would quite put it that way. I think that an effective system of oversight is critical to the way the whole system operates. We feel that when it comes to making position limits on exchanges in the individual cases, that they are closer to it, and that you monitoring that system will be more effective in terms of getting the outcome you are looking for.

The CHAIRMAN. Somebody on a previous panel talked about having the people that actually utilize the system be the same ones that decide what the position limits are in their various areas. Do you agree with that?

Mr. KASWELL. Well, if there were no mechanism for oversight, I wouldn't take that point. But, as long as there is a strong system of oversight, then I think that there are economic incentives for the exchanges to monitor and make sure they are doing the right thing.

I also think that your efforts with regard to clearing are important, and we support that general goal. I think as more products get moved into the clearing environment, that it will address risk overall in the whole system. So I applaud you for looking at this across the board.

The CHAIRMAN. So the oversight you are talking about would be oversight from the CFTC. Is that what are saying?

Mr. KASWELL. On the exchanges and boards of trade, yes, sir.

The CHAIRMAN. You are not relying on us?

Mr. KASWELL. Indirectly, yes.

The CHAIRMAN. You might be in trouble there.

All right, thank you very much.

Mr. LUCAS. No questions.

The CHAIRMAN. Mr. Lucas passes.

Mr. Boswell.

Mr. BOSWELL. Well, thank you very much. I am sure you heard some of the discussion we had earlier today.

Welcome to Mr. Book.

I would like to address a couple of things to you in a language I understand a little better. As you develop clearing services for the CDS market, what are the special safeguards you are considering to address your members' large exposures for CDS products given a credit event?

Mr. BOOK. First of all, if we look at the function of central clearing, it is worthwhile to point out the principal difference to all the other market participants is that the clearinghouse always has a balanced portfolio and position. There are several lines of defense that the clearinghouse will put into place to collateralize all the risk that the market participants hold.

First of all, it is the margining, and part of the margining is a daily mark-to-market, daily articulation of the profits and losses of those holding positions. This is a major difference for many of the current standards in the OTC markets, so that there is always the situation that the market participants are in a position to cover their losses.

The clearinghouse will also calculate margins, especially for the CDS market where it is pretty important to cover credit events. We have developed a risk concept that is especially designed to address the situation of credit events. As you know, these contracts contain a binary risk component in the event default occurs.

In addition to that, there is a mutual guaranty fund which is funded by the clearing participants. We will set this up in a way that it is segregated from the credit default swaps business. In the end the clearing participants will hold a mutual guaranty fund to cover the risks that are coming out of that position. All of that is really designed to make sure that the positions that are held by the clearing participants are adequately collateralized so that the clearinghouse is always in a position to liquidate the position should there be a default situation.

Mr. BOSWELL. Thank you. To continue, are there any U.S. reporting requirements that may be inconsistent with European laws? More broadly, what do you see as the major challenges to greater cooperation between U.S. and European regulators?

Mr. BOOK. First of all let me respond to that, Congressman. The earlier suggestion was made here that the approach of having a European clearer might be protectionist. I think we would clearly say that we do not agree with that. Like the U.S. clearinghouses, we would operate globally as a European clearinghouse, and we believe that having a single mandated sort of worldwide monopoly clearinghouse would be clearly not an appropriate model for this market. But it is much more appropriate as the approach taken here in this bill to embrace competition.

To the extent that the European market can be better served by a local European clearinghouse operating in that time zone like we are, European market participants will have that opportunity, and the European clearinghouse has the benefit of focusing on the European defined contracts which might differ from the U.S. contracts; and therefore can address the market peculiarities of the European market.

With regards to the specific reporting schemes, our lawyer would probably prefer to come back on whether there are particular points to be raised in that regard.

Mr. BOSWELL. Okay. Thank you very much.

I guess I have a little bit of time left. CME Chairman Terry Duffy testified against the clearing provisions, stating he didn't think they would prove to be practical because over-the-counter dealers may not embrace clearing. As another exchange that also has a clearinghouse, what do you think of his views?

Mr. BOOK. Probably I will make a general comment in commending Mr. Duffy. I think in the last testimony also that was held here, I clearly made the point that mandatory clearing is required as an approach to change bilateral market structures in this market. And as we have seen over the past years, the economic incentive to migrate the current bilateral structures, and also the very much forward market, is not sufficient to come to a central clearing structure that is the standard like in all futures options markets.

The approach to mandate clearing for suitable contracts is the right approach because it is a huge challenge and task to migrate this very significant asset class to central clearing market structures. And, of course, one of the changes is to get the right transition of the current positions that are pending to a central clearinghouse. One of the approaches that we have suggested, and want to take, is that we can download the existing business in the DTCC Warehouse to facilitate that transition, and that also refers to the common denominator in my testimony. I think the CFTC should take a practical approach in their exemptions for those contracts that cannot be, sort of, on day one cleared.

Mr. BOSWELL. Thank you very much. My time is up. I think I can say for all of us, we want to have this world community to work, but we are going to have to grow together.

The CHAIRMAN. Thank you, Mr. Chairman.

The gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman.

I guess we are trying to address here two related but different problems. One, the recent economic crisis that seems to have been compounded by systemic risk caused by an interwoven relationship that is very difficult to understand, as a result of the fact that this is a very opaque market. There are a lot of people that are involved in the market, and there would be lots of different ways of addressing that. Certainly clearing could be one.

You have heard, I guess over the couple days, the different discussions we have had about clearing and compromises with regard to clearing. We started this legislation last summer though, because we were quite concerned about the volatility of commodity markets. And we passed legislation in the late summer or early fall that was designed to address that problem.

I guess I would like to hear Mr. Kaswell and Mr. Rosen's thoughts, but I am going to have to make it a hypothetical question to you. I would like you to assume that we have concluded that passive investment money, it has been described as index fund money, *et cetera*, is a culprit in the sharp rise in commodity prices. Not necessarily all, some of it is demand-driven. But let's assume that we have concluded that a substantial amount of the upswing, and now a substantial amount of the downswing, is explained by the presence of this money in these markets that hasn't been there before. It is a fairly recent phenomena. And what we would like to do is figure out a way to have the markets go back to functioning appropriately as they had, or at least functioning as well as they did, not perfectly, of course, but as well as they did prior to the presence of this money.

A number of different suggestions have been made. One is aggregate position limits across all markets, so OTC, on-exchange. Other suggestions have been position limits that apply only to the exchange-traded commodities and not to the OTC market. Others have suggested that the CFTC needs to be given some tools that would be a combination of maybe position limits and possible exemptions, and directed to minimize the inappropriate impact as we find it to be, of this kind of passive money or index money, or whatever you want to call it, in the futures markets, rather than directing the CFTC to set equal position limits, *et cetera*.

I would like to hear you guys, your thoughts, if we are trying to accomplish this, how we would best go about accomplishing this without otherwise messing up the market?

Mr. ROSEN. Thank you for the question, Congressman Marshall.

The first question I would ask about your observations: The markets are dynamic and they do evolve, and you are right that some of the price behavior that was observed was observed during a period in which new sources of investment money were coming into the markets. And one of the things that I think it is important to do is look at the short-term trend and the long-term trend, and decide whether in the long term the presence of those may be stabilizing and not destabilizing.

I would also say that I think it is important.

Mr. MARSHALL. I just want you to assume that we have concluded that they are destabilizing. It is because they have a different interest. It is a longer-term view of things. They have been instructed to take a position that is just part, say an endowments fund, and it is part of our portfolio management strategy. We are going to take a position in commodities, and the way we choose to do that is we go through Goldman Sachs' Commodity Index Fund, stay longer, we do it some other way, but basically we effectively get on the futures market as a way to hedge our long-term position. We have done that, and we are not really acting like the traditional speculator, each day trying to figure out where things are going.

Mr. ROSEN. Right. In that event, you are left to requiring that the CFTC have transparent insights into the positions that affect those markets. And clearly the linkages that exist between the various markets are critical to that, including the over-the-counter positions, but also physical positions. I think if you had a position in that approach which didn't take into account physical provisions, which many people would observe have a more direct influence or ability to influence prices and market liquidity and available supply, is going to be an inadequate tool.

Having said that, I don't think you would have any choice if you were trying to give the CFTC the tools that it needed to deal with situations where the conclusion was reached that markets are disorderly as a result of this excessive speculation. You would have to give the CFTC the ability, and it may already have this under the statute, to go in and say these we are putting position limits on, or reducing them, or reducing the amount that you can take advantage of during this period while the markets are exhibiting this pricing behavior, I think it is a situation——

Mr. MARSHALL. Would that be across-the-board or would that be with respect to specific markets?

Mr. ROSEN. I would say it would be with respect to the markets that are disrupted.

Mr. MARSHALL. So it is just the markets. It is not the individuals who are in those markets?

Mr. ROSEN. Well, I think that you would have to go to the large positions in those markets and you would have to determine what levels, for example, it was necessary to establish for the relevant strategies in order to accomplish the level of market exposure that you think is consistent with getting the market to the right price. If you could figure that out, I think it is a very, very difficult undertaking.

Mr. MARSHALL. Sure. Mr. Kaswell?

Mr. KASWELL. Thank you. One point I feel duty bound to make is that the index funds that you are describing are not hedge funds. Hedge funds tend to be on both sides of the market and they don't tend to drive markets wildly up in one direction or down in another, by definition.

Mr. MARSHALL. You are part of our price discovery team, providing liquidity.

Mr. KASWELL. Yes, sir. We provide liquidity. And we take positions——

Mr. MARSHALL. You in fact have white hats on. You are the good guys.

Mr. KASWELL. Absolutely.

Mr. MARSHALL. Having said that——

Mr. KASWELL. Okay. I think that we appreciate that the bill has different provisions to collect more information about the markets, which we think is a good idea before making some of these judgments. Your question asks about additional position limits and the need for that.

I guess I would say that I would agree with what Ed Rosen is saying, that it would depend on what authorities the CFTC already has, and look to them to try to make good judgments about the amount of position limits that would be necessary.

Mr. MARSHALL. Do you agree, Mr. Rosen——

The CHAIRMAN. Gentlemen, I have to go to a peanut meeting. I want to turn this over to Mr. Boswell to finish off the hearing if Mr. Moran has a question. Then you can keep going if you want.

We are trying to figure out whether we are going to have another hearing next week. As is typical, the SEC and the Fed don't want to come and talk to us. We will have to figure out what we are going to do. But I do, for those of you, we are going to sort through this stuff and start looking at these sections that were criticized, and see if there is some way we can bring some sort of consensus amongst ourselves.

But unless something happens here, I would be planning to try to move this to markup next week at some point before we get out of here. So I am going to be around the next couple of days and we will start trying to bring this together.

Mr. Boswell, if you will take the chair. I thank the witnesses. I will have to head out. If you didn't mind answering a couple more questions.

Mr. BOSWELL [presiding.] Mr. Marshall.

Mr. MARSHALL. Just one last question. Mr. Kaswell, do you agree? Mr. Rosen observed and I acknowledged that you qualified that by saying, as new money moves in, it can have anomalous effects and maybe over time those anomalous effects could die down? Same impression?

Mr. KASWELL. I am not sure that I focused necessarily on the new money *per se.* I think it is a matter of what motivated that new money to come into the market. Was it done as part of a change in the marketplace, some other new event or change in technology? Those kinds of things you would want to look at. So I think you have to look at——

Mr. MARSHALL. A different investment objective?

Mr. KASWELL. All of those things, yes, sir.

Mr. MARSHALL. And that is the contention by many, is that there was simply an investment objective that was being served by this new money coming in.

Mr. KASWELL. Well, there have been many studies with respect to oil, and there are different views on that. In our view, a lot of that was based on fundamentals. The index players added momentum to it, but if you are going to establish these kinds of limits, which is the premise of your question, it has to be a sophisticated analysis to make sure that you are filtering out the behavior that you didn't like and letting through the——

Mr. MARSHALL. Get rid of the bad money and keep the good money.

Mr. KASWELL. It is not easy.

Mr. MARSHALL. Thank you, Mr. Chairman.

Mr. BOSWELL. You are welcome.

Mr. Moran.

Mr. MORAN. Mr. Chairman, thank you very much.

Let me take this opportunity to congratulate you on becoming the Subcommittee Chairman on General Farm Commodities and Risk Management, a Subcommittee that I chaired at one point in time. And now I am your humble Ranking Member, and I look forward to working with you.

Mr. BOSWELL. Remember to be with me now—some of the things that I read in the paper you might be doing.

Mr. MORAN. I look forward to working with you, Mr. Chairman, to the nth degree.

Mr. BOSWELL. And I wish you well.

Mr. MORAN. Thank you so much.

I have a couple of questions. I explored this with the previous panel and what I think I see in this draft, and what I hear from a number of witnesses, is that we are headed down the path of a forced clearing with a narrow exemption. And I just wanted to explore one more time what does anyone think the alternative should be to that. Is there an easy way to summarize that?

Mr. ROSEN. I think the question is how is it administered and what is the right way to get to maximizing clearing where it is appropriate. I think one of the fundamental problems is the equation is reversed. I think to say the default is that you must clear or you must come in and describe to somebody that this transaction isn't sufficiently customized and transactions are sufficiently infrequent, is an inherently flawed process.

If you think about the way these products evolved, you would never have the certainty without knowing, well, what are other firms doing with that product? What is highly customized? And you would have people going to the regulator and trying to get comfort, to get individual transactions executed. I think that is the kind of inefficient friction that we would want to avoid.

On the other hand, it is very clear to the regulators who obtain information about the transactions that are being executed when there are huge numbers of standardized transactions that are being executed. So, it is a far better standard to say you have to clear them once that determination has been made. But, as I said, I don't think the CFTC has the information to even begin to make that decision. They are not the supervisor of the major global banks who do this. That is not their job.

We think that a far more effective approach would be to take advantage of the prudential supervision of the largest participants in the market, and that entity can determine when it is appropriate to require that the entities that it supervises are appropriately clearing their transactions. With respect to those that are not cleared, they should decide what ought to be the implications. What are the capital requirements that should be imposed for incremental risks that are created by having a large book of customized OTC transactions that are not subject to the disciplines and multilateral netting benefits of being in a clearing system?

Mr. KASWELL. If I may, one thought that we put in our testimony, this is a little chicken-and-egg problem. The members of MFA are concerned that, while we are all very eager to see this happen quickly, that we are being asked to sign up for a system that is coming along. We are very optimistic that it will happen, but we don't want to sign up for something that we haven't seen, or be forced in the bill to do that. So how do you cut through that?

Well, if there were many reporting requirements, oversight hearings, that sort of thing to keep the pressure on, that you would find the market would move there. Because there is an appetite for it in the private sector because of the very benefits that everybody agrees comes from clearing, and that you would find that many of the products would be in that cleared environment where it is appropriate. Some could get this sooner than later; and others you might not want to do it at all. As we all understand there is still a need for customized products. But, oversight and vigilance might work or get you where you are trying to go.

Mr. MORAN. Thank you.

I have one more question, Mr. Boswell.

This again may be to you, Mr. Rosen, because I notice that you took up the issue of foreign boards of trade. I introduced legislation last year to try to address this issue as well, and I worry that what we may be doing in the bill that is before us is allowing another loophole to occur.

I guess my question is, with this current approach in this draft bill, would it just cause foreign boards of trade to close their trading desks in the U.S., but then continue to contract overseas where U.S. traders will continue to have access to the market where the CFTC doesn't have oversight?

Mr. ROSEN. I wouldn't want to make the knee-jerk reaction that as soon as the government does something that is potentially unpleasant that people will close off their access to or from the United States.

I do think that if it was perceived that the standards that would be applied in the United States did not reflect the judgments of the international community, and that the manner in which the objective of sort of controlling speculation were being imposed prescriptively by the United States, there could be a couple of reactions. One reaction is in the regulatory community. I think it could invite retaliation and just another view that the United States is yet again being imperious when it is not necessary to do that.

But to the extent that the market perceives that those constraints that are created by the imposition of those requirements on a foreign board of trade are going to impair the market, you could expect that. This is not just the foreign board of trade provision, Congressman Moran. I think it is related to a lot of the other provisions that impose constraints.

If they are perceived as not conducive to the efficient operation of the market, there are no major traders certainly in the financial space that I am aware of who are not able to organize their affairs so that they can trade on foreign exchanges without a nexus to the United States.

And I do have a concern that if we rush to judgment and try to solve short-term problems with long-term solutions that undermine the efficiency of the market, or are perceived by the market to undermine the market efficiency, those folks will be trading those products abroad. There is no reason why West Texas Intermediate crude is the price discovery contract for crude oil, other than the fact that we have been successful in developing highly efficient and low-cost markets. Most of the world transacts in forms of crude oil other than WTI. It is a small percentage, as you know.

So I do have a concern that, if that were to transpire, there are many commodities that could be traded on foreign markets; and we would lose control over the regulation of those markets entirely. And if those markets are outside the United States, those markets will not even necessarily trade in U.S. dollars. It is not necessary for crude oil on the world stage to trade in U.S. dollars.

I am not sure how it would advantage us to encourage the development of foreign markets driving the prices of stable commodities that our economy depends upon, and move those in a direction of trading in currencies other than the U.S. dollar. I think we do need to be concerned about those effects.

Mr. MORAN. Thank you for sharing your expertise.

Thank you, Mr. Chairman.

Mr. BOSWELL. You are very welcome.

Anyone else? Mr. Marshall?

I think that concludes our panel today. We cannot thank you enough for your time, your presence. I also think it is fair and reasonable to say we are going to need to continue the dialogue. As I think you may have heard earlier today, we have to do this right. We are counting on your input.

So, again, thank you very much, and we will call this meeting adjourned.

[Whereupon, at 3:18 p.m., the Committee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED STATEMENT OF HON. BART CHILTON, COMMISSIONER, U.S. COMMODITY FUTURES TRADING COMMISSION

I commend Chairman Peterson for his continued leadership and support his efforts to restore the public's confidence in U.S. futures markets by ensuring appropriate oversight. The proposal incorporates needed changes to our current regulatory structure that will greatly improve our ability to protect consumers and businesses alike.

In a speech last week, I quoted the American folklorist Zora Neale Hurston, who said; "There are years that ask questions, and there are years that answer." This year must be a year of answers. During my remarks, I went on to lay out what I see as necessary steps to healing our fractures in our regulatory system. I'm pleased that the Chairman's proposal also addresses several of these critical components.

(1) Require OTC reporting and record-keeping. This will enable the CFTC to examine trading information, particularly information about sizable, look-alike or price discovery transactions that could impact regulated markets—markets that have a bearing on what consumers pay for products like gasoline or food, or even interest rates on loans.

(2) Oversee mandatory clearing of OTC Credit Default Swap (CDS) transactions, and encourage clearing for other OTC products as appropriate. The stability and safety of our financial system is significantly improved by enhancing clearing systems for CDSs—in a manner that does not lead to cross-border arbitrage—as well as for other OTC derivatives. Such clearing would not only provide counterparty risk, but a data audit trail for regulators.

(3) Regulate OTC transactions if the Commission determines that certain trades are problematic. The CFTC should be given the authority to determine and set position limits (aggregated with exchange positions, and eliminate *bona fide* hedge exemptions) to protect consumers. Congress should also extend CFTC anti-fraud, anti-manipulation and emergency authorities as appropriate to OTC transactions to allow greater openness, transparency and oversight of our financial markets. These provisions are included in the Chairman's proposal. I am hopeful that the Committee will also consider two other items, one within its jurisdiction—the other an appropriations matter.

(4) Public Directors on Investment Industry Boards. Corporate boards would benefit greatly from the inclusion of public directors who bring a diversity of backgrounds and experiences to the boardroom. Such a provision would allow farmers, consumer representatives or other individuals to serve and provide different, yet important perspectives. All too often, these boards look more like an extension of the companies themselves than a group of individuals that are there to spot problems and deliver constructive criticism. Unfortunately, what we witnessed in the securities world is that this had to be mandated rather than simply encouraged. For that reason, I would urge Congress to consider a requirement that a third of board members be considered public directors.

(5) Congress should appropriate immediate full funding ($157 million for Fiscal Year 2009) in additional resources, which would allow the CFTC to hire an additional 150 employees, and fund related technology infrastructure so that the agency can properly effectuate our duties under the Commodity Exchange Act, as amended by the farm bill. Many in Congress have joined together to call for increased resources for the Securities and Exchange Commission (SEC). By comparison, the CFTC oversees exchanges with significantly greater market capitalization than the SEC. For example the CME Group alone has a market capitalization of roughly $11 billion, while NYSE/Euronext (largest U.S. securities exchange regulated by the SEC) has a market capitalization of $5.5 billion. The SEC has 3,450 employees, while the CFTC struggles with roughly 450—fully 3,000 less staff. It is not a popular thing to call for more money for Federal employees, but cops on the beat are needed to detect and deter crimes. The CFTC needs these additional resources and we need them now.

There are many other provisions in the Chairman's proposal that I support, such as closing the London Loophole and ensuring exclusive jurisdiction over environmental futures market regulation. Simply put, the success of a cap-and-trade system requires an experienced regulator. The Chairman's proposal, if enacted, will bring much needed transparency and accountability to both over-the-counter and certain overseas markets; provide the CFTC the authorities necessary to prevent market disruptions from excessive speculation; and give regulators a window into currently "dark markets" by requiring reporting and record-keeping.

SUPPLEMENTAL MATERIAL SUBMITTED BY MICHAEL W. MASTERS, FOUNDER AND MANAGING MEMBER/PORTFOLIO MANAGER, MASTERS CAPITAL MANAGEMENT, LLC

Dear Congressman Marshall:

Thank you for your insightful questions and your leadership on the issue of excessive speculation. I wanted to respond promptly to your request for written answers to the two questions you posed during the hearing.

Your first question pertained to a scenario wherein the commodities derivatives markets are balanced, with an equal number of speculators seeking trading profits on the one hand, and physical producers and consumers hedging their real business on the other. What happens, then, if a large number of "invesculators" enter the markets? What problems would that pose and what solutions would we need?

I believe the scenario you describe is precisely what has happened to our commodity markets in the last 5 years, culminating with the extreme price movements of the last 18 months. "Invesculators," as you referred to them, are extremely damaging to the commodities derivatives markets, due to their belief that commodities are an "asset class." Commodities are raw materials that are consumed by individuals and corporations. They are not an "asset" (like a stock or a bond) that can be bought and held for the long term. As much as institutional investors want to believe that commodities can be considered assets, they simply cannot.

Physical hedgers—those who produce and consume actual commodities—never suffer from "irrational exuberance." When prices rise, producers are motivated to produce more (that's their business), and consumers are motivated to consume less. In contrast, the "Invesculator" responds to an increase in price by thinking, "oh, that would be a good investment," and jumps on the bandwagon by submitting their own buy orders. This is the dynamic that causes price bubbles to form. Every capital asset category has had its bubbles through history: the Japan bubble, the emerging markets bubble, the Internet bubble, the housing bubble, the credit bubble, *etc.* Eventually, wherever investors go, price bubbles appear.

When physical hedgers dominate the commodities derivatives markets then traditional speculators, because they are outnumbered, will emulate the behavior of the physical hedgers. But when speculators rule these markets then they can drive prices to irrational heights that have nothing to do with supply and demand. In the scenario that you described, wherein five speculators and five physical hedgers are transacting in the derivatives market, and then 45 "invesculators" show up, the result is a bubble, just as if you put your house on the market, had an open house, and 45 people showed up with their checkbooks. You're going to get a much higher price than if no one, or even a couple of people, showed up.

While bubbles in asset markets can be intoxicating, bubbles in commodities are devastating. Every human being around the globe suffers when we experience bubbles in food and energy prices.

So what can Congress do about it? Fortunately, the solution is simple, and Congress has already done it since 1936: put a limit on the size of positions that speculators can hold in order to prevent them from dominating the market. This worked superbly from 1936 until about 1998. It is simple and proven, and carries no unintended consequences.

Unfortunately in 1998 the CFTC began to let speculative position limits slide. For them the term "excessive speculation" came to mean basically the same as "manipulation." At which point the CFTC decided position limits were only necessary to prevent manipulation. Then, in 2000 the Commodities Futures Modernization Act (CFMA) allowed the formation of the Intercontinental Exchange (ICE), and exempted over-the-counter (OTC) swaps dealers from all regulation. The result was that there were no longer any real speculative position limits in energy. Also, the OTC markets effectively rendered position limits in agricultural commodities meaningless. What ensued was rampant speculation, which led to the bubble that finally burst in the second half of 2008.

It's easy to see why it is not only essential to reinstate a system of speculative position limits on the exchanges, but it is also critical for those limits to apply to ICE and other exchanges, as well as the OTC markets. When there is a clearly defined limit placed on the money flowing into a market, then prices cannot expand fast enough to cause a bubble.

Your question seemed to also pose a more nuanced scenario: assuming a market in which the speculative position limit is, for example, 1,000 contracts, and further assuming that 50,000 contracts are held by speculators and 100,000 contracts are held by physical producers and consumers, what if 300 new speculators show up and they all stay below the 1,000 contract limit, they can still buy 300,000 contracts combined, what should be done then? The answer is that speculative position limits need to be adjusted as market conditions dictate.

This scenario provides an excellent illustration of why we recommend the formation of a physical hedgers' panel that would serve to adjust speculative position limits every 3–12 months. If the ratio of speculators to physical hedgers becomes too high (like 350,000 : 100,000—which, for reference, was the approximate ratio in 2008), then the panel should lower the speculative position limit from 1,000 contracts down to, say, 500 contracts. Similarly, if the ratio of speculators to physical hedgers is too low and the markets need more liquidity, then the panel would have the ability to raise the limit to allow speculators to take larger positions. Think of speculative position limits like a valve that controls the level of speculative money in the markets, as well as the speed with which money flows into the markets.

We believe that the optimal ratio of speculators to physical hedgers is one to two (34% speculative). The commodities futures markets operated efficiently with no liquidity issues for decades while open interest stayed generally in the range of one speculator for every four physical hedgers. So if the physical hedgers' panel would target a ratio of one speculator for every two physical hedgers that would give the commodities derivatives markets abundant liquidity.

Your second question pertained to the possible challenges of implementing across-the-board speculative position limits. The simplest and most effective way to implement speculative position limits is to enforce an "aggregate" speculative position limit that a speculator will face regardless of the transaction venue (*e.g.,* a CFTC-regulated futures exchange like NYMEX, a non-CFTC-regulated futures exchange like ICE, or in the OTC market). Let's say that the physical hedger panel determines that the speculative limit for oil should be 5 million barrels or 5,000 contracts. Speculators would be told that they can buy up to 5 million barrels anywhere they want as long as they do not exceed this limit.

Consider the problems that can arise if a system of speculative position limits is not established on an aggregate basis and instead individual trading venues are assigned their own unique limits. No matter what system is used for assigning those limits it will run into problems. As an example, if the aforementioned 5,000 contract speculative position limit for crude oil is apportioned as follows:

NYMEX: 1,000

ICE: 1,000

OTC: 1,000 contract equivalent (1 million barrels)

IPE: 1,000 (International Petroleum Exchange)

DME: 1,000 (Dubai Mercantile Exchange)

Then, under this scenario, speculators will be forced to spread their trading around in order to access their entire 5,000 contract speculative position limit. Since the amount of liquidity varies from one exchange/venue to the next, it would not make sense to encourage an equal amount of trading on each venue. For example, ICE has half the volume of NYMEX, so should they have the same limit as NYMEX or half the limit of NYMEX?

Different problems arise however if unequal speculative position limits are imposed. If the limits were set to match current liquidity like this:

NYMEX: 1,000
ICE: 500
OTC: 2,500
IPE: 800
DME: 200

Then the growth of ICE and other exchanges would be stunted due to their low relative limits. This system has the further effect of forcing speculators to trade OTC in order to reach their 5,000 contract maximum. This is not something that I believe Congress wants to do.

If limits are placed on some venues but not others, then trading will flow to the places that offer unlimited speculation (currently the OTC markets). This would fail to safeguard against future speculative bubbles, which is what the speculative limits are designed to do.

The best system for implementing aggregate speculative position limits would entail the following:

(1) All OTC commodity derivative transactions must clear through an exchange.

(2) Each speculator would have a trader identification number which would be associated with every trade, just like a customer account number.

(3) Foreign boards of trade would have to supply information to the CFTC on U.S. traders (looking at the parent entity level).

Those who oppose exchange clearing will complain about "chicken fat" swaps and the like, but in reality, 99% of all commodity swaps are composed of futures contracts and basis trades, which would all clear. Congress should resist attempts by Wall Street to avoid exchange clearing by claiming that their derivatives are too exotic and that therefore large segments of the market need to be exempted from the clearing requirement. Almost all OTC commodity derivatives should clear.

As part of the clearing process OTC derivatives are transformed into futures contract equivalents. Therefore the process of applying speculative position limits to OTC derivatives that have exchange cleared is as simple as applying limits to futures contracts. Under this system of speculative position limits and exchange clearing, the aggregate activity for an individual trader can be calculated simply by tracking the trader identification number and adding up how much each trader has bought through each venue in each commodity.

A trader who exceeds their limit could face a stiff financial penalty (100% of which can go to the CFTC to fund their operations) and that trader's positions could be liquidated on a last-in, first-out basis.

In order for this regulation to capture transactions on foreign boards of trade, they must be required to submit the necessary information to the CFTC on a real-time basis in exchange for the CFTC allowing them to place direct terminals in the United States. The CFTC has many "hooks" that would allow them to ensure that aggregate speculative position limits apply to foreign boards of trade as well.

In summary, the idea is to give speculators one limit and let them "spend" it wherever they see fit.

I hope I have clarified why aggregate speculative position limits and exchange clearing are the surest protection against a future commodity bubble. Please let me know if I can be of any further assistance.

Best regards,

MICHAEL W. MASTERS,
Portfolio Manager,
Masters Capital Management, LLC.

SUBMITTED STATEMENT OF NATIONAL GRAIN AND FEED ASSOCIATION

The National Grain and Feed Association (NGFA) appreciates the opportunity to submit the following statement for the record of the Committee's hearing on draft legislation titled the "Derivatives Markets Transparency and Accountability Act of 2009."

The NGFA is the national association representing about 950 companies in the grain, feed and processing industry and related commercial businesses. The NGFA's member companies operate more than 6,000 grain handling and processing facilities nationwide. These companies are the traditional users of U.S. agricultural futures markets like the Chicago Board of Trade, the Kansas City Board of Trade, and the Minneapolis Grain Exchange. The NGFA's members rely heavily on products traded on regulated exchanges for price discovery and to manage their price and inventory risks. Properly functioning contracts and transparent markets are of the utmost importance. For these reasons, the NGFA's input on the draft bill goes more directly to futures market-related provisions than to proposed changes in the regulation of derivative products.

Contract Performance and Impact of Investment Capital

The NGFA and its member firms have been extremely concerned during the last 3 years about performance of the CBOT wheat contract. We believe strongly that participation of investment capital in the CBOT wheat contract—a fairly recent phenomenon that has reached significant levels—has contributed to a disconnect between cash prices and futures prices on-exchange. This disconnect has made it difficult and costly for grain hedgers to rely on the soft wheat contract for hedging purposes and efficient pricing and has contributed to soft wheat basis behaving in ways that would not be expected historically. Together with serious concerns about financing margin calls on their hedges, which came to a head last spring and summer, and today's worries about the availability of sufficient credit, grain elevators have not been able to offer the same broad range of cash grain marketing opportunities that producers have come to expect.

The NGFA believes that the draft legislation being discussed in the Committee on Agriculture contains several provisions that will help bring added clarity and transparency to agricultural futures markets. While not a guarantee of enhanced performance, these provisions will allow all market participants a better view of the marketplace and enhanced decision-making based on who is in the market and whether activity is based primarily on investment activity or true supply/demand fundamentals.

In particular, the NGFA supports the detailed reporting and data disaggregation language found in section 4 of the draft legislation. We believe identification of index traders and swaps dealers who are active in agricultural futures markets in reporting by the Commodity Futures Trading Commission (CFTC) will assist grain hedgers in making appropriate risk management decisions. The NGFA would suggest that additional legislative guidance be given to the CFTC to identify any additional market participants whose trading behavior may be similar for purposes of potentially including those participants under the same reporting requirements.

Position Limit Agricultural Advisory Group

Section 6 of the draft legislation would establish a Position Limit Agricultural Advisory Group. The NGFA would suggest that, at least for the grains and oilseeds contracts, the current method of determining speculative position limits is working well. Typically, if changes in position limits are contemplated, a regulated exchange would propose the new limits for a specific agricultural futures contract, often following consultation with affected market participants; the CFTC would analyze and review these levels and evaluate input from the public and relevant futures market participants during a public comment period; and the Commission then would either approve or disapprove the proposed change in position limits. From the NGFA's perspective, this process has worked well, and we believe our industry has participated in a meaningful and effective way. For grains and oilseeds, we believe the current process is preferable to a broadly drawn advisory group that may not have sufficient expertise with each individual contract (*e.g.,* most grain industry representatives on an advisory group would have little expertise in advising on position limits for cotton).

Concerns About "*Bona Fide*" Hedging Definition

The NGFA's primary area of concern in the draft legislation is provisions in section 6 that would specifically define in law how the CFTC must define a "*bona fide*" hedge. We fully support the draft bill's intent: to distinguish between traditional hedgers who use futures contracts for price discovery and to hedge their price and inventory risks in cash markets, and newer, non-traditional participants who view futures markets as an investment category. For some time, the NGFA has made the case that investment capital's participation in agricultural futures markets has artificially inflated futures prices, skewed basis relationships and, especially in the case of the CBOT wheat contract, eroded the utility of futures markets for traditional participants.

However, we strongly believe that legislating a concept as complex as defining a "*bona fide*" hedge—and, by extension, which entities should qualify for hedge exemptions—is fraught with risk. Even with the best of intentions, codifying this concept invokes the "law of unintended consequences." We fear that a strict construction could unintentionally lay a snare for legitimate hedgers—and at the least, could have a constrictive effect on development of hedging strategies that benefit agricultural producers. We strongly urge the Committee to signal its intention to the CFTC on parameters of a "*bona fide*" hedge, but we also strongly urge that the Commission ultimately be allowed to develop and administer the definition. We would be very happy to work with the Committee to help structure such an approach.

Exchange Clearing of Over-the-Counter Transactions

While the NGFA does not have a formal Association position on requiring reporting or exchange-clearing of OTC transactions, we would offer a couple of observations and a caution as the legislation proceeds. We are aware that some agricultural grain buyers and processors have structured a range of OTC products that back up and complement their cash contract offerings to producers and other customers. We are not aware that these useful OTC agricultural products, which provide tailored marketing opportunities to producers and others, have experienced the same problems as credit default swaps and other financial derivatives.

Futures contracts are traded and cleared very efficiently on regulated exchanges because contract terms are standardized. Due to the very nature of OTC products—which typically are customized, individually-negotiated agreements—attempting to force them through an exchange's clearing corporation could present difficulties and likely would inhibit development of new marketing tools for agricultural products. We would caution against such a result. Perhaps an approach involving reporting of OTC participants and/or transactions would be a reasonable alternative approach.

We appreciate the opportunity to submit these thoughts and recommendations. The NGFA stands ready to answer any questions or provide assistance to the Committee as the legislation proceeds.

SUBMITTED LETTER AND STATEMENT OF SUSAN O. SELTZER, FORMER ASSISTANT VICE PRESIDENT, SYNTHETIC SECURITIES, U.S. BANK

February 12, 2009

RE: Derivatives Transparency Act of 2009
Credit Default Swap Legislation

Congressman Peterson
By FAX: 202 225-1593

Dear Congressman Peterson:

Time is of the essence for the American taxpayer regarding minimizing the outflows under financial institutions existing and future collateral positions under credit default swaps. Every day that goes by without legislation on credit default swaps is hurting the U.S. taxpayer.

It is my understanding, that I am the only party that submitted written testimony on the Derivatives Transparency Act of 2009, on behalf of U.S. taxpayers. To be effective in gaining the protection we need to minimize the future costs to U.S. taxpayers, it is imperative that you meet with the one citizen who is opposing the stance of Wall Street on credit default swaps.

May I meet with you as soon as possible, in your Minnesota office, concerning the Derivatives Transparency Act of 2009?

Please let me know when it would be possible to meet with you concerning the issue of credit default swaps regulation under the Derivative Transparency Act of 2009.

Thank you.

Sincerely,

Susan O. Seltzer

Attachments:

Written Testimony to Derivative Transparency Act of 2009 (February 4, 2009)
MinnPost Article Feb 4, 2009 "Join Rep Peterson in Solving the credit default swap mess"

ATTACHMENT 1

February 2, 2009

Hon. COLLIN C. PETERSON,
Chairman,
Committee on Agriculture,
Washington, D.C.

RE: Derivatives Markets Transparency and Accountability Act of 2009

Dear Congressman Peterson:

Please consider adding to the Draft Language of "Derivatives Markets Transparency and Accountability Act" the stipulation that it would be mandatory for all counterparties to credit default swaps to unwind these contracts, going back to January 2007. The parties to these contracts would exchange profits and losses, alleviating the U.S. taxpayer from taking on the credit default swap counterparties obligations. Shifting this burden to the U.S. taxpayer has not solved the problem and it very well may be a continuing outflow of taxpayer dollars that could be more efficiently invested to generate a higher return, say in jobs, education or infrastructure.

This perspective comes from thirteen years in the over-the-counter derivative markets at a major U.S. commercial bank when the swaps markets were first developing in the early eighties. My experience included advising corporations on the use of swaps, foreign currency forwards and options for hedging transactional and translational foreign currency exposures in the inter-bank market. For the commercial bank's executive credit committee, I prepared the analysis of the counterparty credit risk in these derivative transactions, including interest rate swaps, which was always monitored on an ongoing basis. I was also involved in ensuring there were appropriate Board approved position limits on all derivative contracts used in the over-the-counter market.

In addition, there is a central issue in 2009 Derivative Transparency that must be resolved prior to finalizing this bill. Please request that Treasury Secretary Geithner's office determine the ROI of using taxpayer dollars for contractual payments under credit default swap contracts. Consider having your bill reverse TARP funds and AIG loans used to date for this purpose. Insert language in the bill, which requires the unwinding of existing credit default swaps. Shift the burden of contractual payments required under credit default swaps from the U.S. taxpayer to the original parties to these contracts, effectively by unwinding these contracts. Unwinding swap contracts is unprecedented, but these times are unprecedented and AIG's right to enter into these contracts in the over-the-counter market, may have been fraudulent.

Yes, all credit default swaps should be traded on a regulated exchange. However, change the language of this bill to ensure there are not any exceptions and there are not any credit defaults swaps contracts in the over-the-counter market.

Finally, have the bill focus solely on credit default swaps use in the over-the-counter markets. Do not require interest rate swaps and foreign currency forwards to operate on a regulated exchange. To add to this bill the regulation of interest rate swaps and foreign currency contracts in the over-the-counter markets will add a layer of complexity and cost to commercial banks that can be deferred, until the financial crisis is resolved.

As you are aware, the defenders of credit default swaps will argue, "They help us have a gauge on corporate credit risk and sovereign risk. These active markets give us spreads that reflect market sentiment on a given credit risk. Market sentiment is not a valid indicator of true creditworthiness."

According to the swap industry, which is promoting the ongoing use of these derivatives, they are critical to our financial markets. "Throughout the crisis, credit default swaps have remained available and liquid," said Eraj Shirvani, Chairman of the International Swaps and Derivatives Association (ISDA) and head of credit sales and trading at Credit Suisse.

"They have been the only means of hedging credit exposures or expressing a view at a critical time for the industry. Impairing their use would be counterproductive to efforts to return the credit markets to a healthy, functioning state."

There is a viable and valuable use for interest rate swaps and foreign exchange swaps and forwards in hedging interest rate and foreign currency exposures. Credit default swaps cannot effectively hedge credit risk. Credit risk, as you are aware, can only be managed by looking at the financials of the entity, at the time of credit extension and on an ongoing basis as market conditions change. Market sentiment developed through trades establishing "an entity's credit worth" have proven to be destructive to our financial system and their advocates have not demonstrated what value the continuing use of them will bring to our financial system. There is far greater downside, than upside, in continuing their use.

One should respond to advocates of the continue use of credit default swaps with these two points:

- Common sense dictates a bank would not give unlimited credit or a jumbo mortgage to a borrower with an income of $50,000 and no assets. Common sense also dictates AIG should not have been allowed to enter into an unlimited amount of credit default swaps with counterparties. The AIG Board of Directors, in allowing AIG's Financial Product division to be created, did not set any parameters for AIG managing counterparty credit risk.
- Merrill had a $15.31 billion net loss in the 4th quarter, first reported 2 weeks ago. "Behind some of the losses in the quarter are two related trades that Merrill hasn't disclosed publicly in detail." It has been reported the loss resulted from a long position in corporate bonds, "hedged by derivatives, credit default swaps." When asked about this 4th quarter multi-billion loss, Mr. Thain responded, "that was a legacy position."

U.S. taxpayers need an answer as to why, when taxpayer funds were used by Bank of America to take over Merrill; these legacy positions were not unraveled, saving us another $15 billion that could have been put into our schools in Minnesota. How many more credit default swap "legacy" positions is the U.S. taxpayer going to be asking to fund?

Thank you, Congressman Peterson, for taking the lead on unraveling the quagmire created by credit default swaps to swiftly restore our banking system to a functioning level. Again, I would recommend Washington listen to a more diverse opinion on credit default swaps. Reforms in this derivative have the appearance of being led by an Executive Branch that comprises many former bankers and economists with a vested interest in continuing to maintain credit default swap profits, while placing the burden of the losses on the taxpayers.

As an unemployed Minnesotan, I would be pleased to come to Washington to work to research other viable alternatives to ensure taxpayer dollars are invested in a prudent fashion, as we work to unwind the aftermath of irresponsible, if not fraudulent, credit default swap financial contracts.

Sincerely,

SUSAN O. SELTZER,
Former Assistant Vice President, Synthetic Securities,
U.S. Bank.

ATTACHMENT 2

MinnPost.com

http://www.minnpost.com/community—voices/2009/02/04/6377/join__rep__peterson__in__solving__the__credit-default-swaps__mess

Join Rep. Peterson in solving the credit-default-swaps mess

By SUSAN SELTZER,
Wednesday, Feb. 4, 2009

Minnesotans have an opportunity to take an active role in partnering with Rep. Collin Peterson, D-Minn., to "effectively" ban the further use of credit *default swaps. Nouriel Roubini,* professor of economics and international business at New York University's Stern School of Business, has cited credit default swaps as a pivotal factor in the collapse of our financial system.

House Speaker Nancy Pelosi has appointed Peterson as her leader to get the derivative mess under control. Last November, he traveled to Europe to meet with international banks to get perspective on how to unwind the credit-default-swap derivative mess, which today still weighs heavily on the ability to restore our financial system. Peterson, who chairs the House Agricultural Committee, has an accounting background and a strong understanding of exchange-traded derivatives, through his committee's work with the Commodity Futures Trading Commission (CFTC).

Draft language for a bill, "*Derivatives Markets Transparency and Accountability Act of 2009*," was posted on the Agriculture Committee's website last week and is being debated in Congress today. One part of this bill serves to place all credit default swaps, interest-rate swaps and foreign-currency forwards currently being traded in the inter-bank or over-the-counter market on a regulated exchange. Certain "customized" credit default swaps may be exempt. The bill proposes that credit default swaps only be used to hedge an underlying bond or position.

Lobbyists are already pushing back

Peterson's proposed bill is already getting strong pushback from lobbyists, including the International Swap Dealer's Association (ISDA) and major banks. The Treasury secretary's nominated chief of staff, Tom Patterson, was a lobbyist for Goldman Sachs until last year. Revenue from financial services firms was over 25 percent of our GDP last year, a significant portion from credit default swaps. There is a strong incentive to maintain this revenue stream, but is this a revenue stream we want?

Taxpayers do not yet have advocates that serve to protect our new ownership interest in AIG and other financial institutions. It may make sense to ask Peterson to consider adding to his bill the stipulation that it would be mandatory for all counterparties to credit default swaps to unwind these contracts, going back to January 2007. The parties to these contracts would exchange profits and losses, alleviating the U.S. taxpayer from taking on the credit default swap counterparties' obligations. Shifting this burden to the U.S. taxpayer has not solved the problem, and it very well may be a continuing outflow of taxpayer dollars that could be more efficiently invested to generate a higher return, say in jobs, education or infrastructure.

This perspective comes from 13 years in the over-the-counter derivative markets at a major U.S. commercial bank when the swaps markets were first developing in the early 1980s. My experience included advising corporate CFOs on the use of swaps, foreign-currency forwards and over-the-counter options for hedging transactional and translational foreign currency exposures. For the commercial bank's executive credit committee, I prepared the analysis of the counterparty credit risk in these derivative transactions.

Seen in '90s as a win-win

It was not until the late 1990s that a J.P.Morgan trader worked to solve the ongoing issue of managing "credit risk" and created the derivative, a credit default swap. The rest is history. There were some vocal skeptics, including Brooksley Born, former chair of the CFTC. Senate Banking Committee testimony in 2005 concluded that the use of credit default swaps was a win-win for all parties and there was no reason not to allow their ongoing use in the over-the-counter markets.

Counterparty credit risk was not managed with credit default swaps, since inception. Players in these over-the-counter markets—like hedge funds, AIG and investment banks—have typically had a different credit-risk orientation from commercial banks. Derivatives, used in the correct context, are powerful tools to hedge interest-rate risk and foreign-currency exposures. Derivatives have been a source of stability and revenue for major banks in both the over-the-counter market and regulated exchanges, and should continue to be. They are used by banks to manage mismatches in loan positions, to hedge risk of floating rate debt, for example. Small Minnesota importers use them, through commercial banks, when they buy products in foreign currency, to hedge their foreign-currency exposure. Hedging with derivatives is a more conservative position than not hedging.

Mostly used for speculation

In contrast, credit default swaps were used for speculation in the majority of cases. Unlike interest-rate swaps and foreign-exchange forwards, they do not provide any underlying value to the U.S. banking system.

(For some recent background on the credit default swap market, *here is a link to a blog, Naked Capitalism* (*http://www.nakedcapitalism.com/2007/08/are-credit-default-swaps-next.html*), from August 2007, which details concerns on the credit default swap house of cards. In addition, a May 2008 Bloomberg story provides good history of how the Federal Reserve appointed J.P.Morgan to oversee the black hole of the CDS market with their takeover of Bear Stearns.)

So what is the next step regarding Peterson's draft bill on transparency and regulation in the derivative markets?

First, ask Treasury Secretary Timothy Geithner's office to determine the efficiency of using taxpayer dollars for contractual payments in credit default swap contracts. Consider having Peterson's bill reverse TARP funds and AIG loans used to date for this purpose. Insert language in the bill that requires the unwinding of existing credit default swaps. Shift the burden of contractual payments required under credit default swaps from the U.S. taxpayer to the original parties to these contracts, effectively by unwinding these contracts.

Second, implement Peterson's recommendations that all credit default swaps must hedge an underlying position. Yes, all credit default swaps should be traded on a regulated exchange; however, change the language of this bill to ensure there are not any exceptions.

Third, and finally, have the bill focus solely on credit default swaps' use in the over-the-counter markets. Do not require interest-rate swaps and foreign-currency forwards to operate on a regulated exchange. To add to this bill the transfer of interest-rate swaps and foreign-currency contracts in the over-the-counter markets to a regulated exchange would add a layer of complexity and cost to commercial banks that can be deferred until the financial crisis is resolved. Do require disclosure and reporting requirements, as stipulated in the proposed bill, on interest-rate swaps and foreign-currency-forward contracts.

Congratulations to Rep. Collin Peterson for taking the lead in unraveling the quagmire created by credit default swaps.

Susan Seltzer is a former Assistant Vice President, Synthetic Securities of U.S. Bank.

Submitted Statement of A. James Jacoby, President, Standard Credit Securities, Inc.

Chairman Peterson, Ranking Member Lucas, and Members of the Committee:

Good morning. My name James Jacoby. I am President of Standard Credit Securities, Inc., a registered broker/dealer and leading provider of execution and analytical services to the global over-the-counter inter-dealer market for credit cash and derivative products. I have been an active participant in both the OTC and on exchange securities markets since 1959 and have witnessed both the successes and challenges in the CDS market. I would like to thank this Committee for the opportunity to share my thoughts on the draft legislation on Derivatives Markets Transparency and Accountability Act 2009, as it applies to the over-the-counter market generally and the credit derivatives market specifically.

The Committee's draft legislation comes at a significant time. In my view, any legislation that attempts to address derivative market accountability and transparency should reflect an historical perspective on the law of unintended consequences as it may arise from such legislation. With this in mind, I would like to briefly comment on two areas of the draft legislation that bear special attention:

- Underlying Bond Ownership Requirements of CDS.
- Unintended Consequences of Inappropriate Regulatory Action.

Bond Ownership as Prerequisite for CDS Transactions

Section 16(a)(h) proposes to make it "unlawful for any person to enter into a credit default swap unless the person would experience financial loss if an event that is the subject of the credit default swap occurs." Such a prohibition would effectively eliminate the credit default swap business in the United States. This provision would strip liquidity from the market and it would cease to function as an effective risk transfer arena. To limit the participants to those who "would experience financial loss" narrows the market to very few participants and eliminates the many sources of liquidity. Essentially, a bond owner who seeks a CDS as a hedge against the potential default, will lack the ability to enter into such a transaction. No one will have the same risk of default that that is being hedged and, at the same time, be willing to enter into a swap. It seems that the only person from whom a swap could be purchased would also have to have exposure to the same default. Would not that person be seeking the same protection? If, for instance, only farmers could trade in the grain markets because of their potential loss, the market would be very thin, spreads very wide and volatility extreme. Speculation, under such circumstances, is not a bad characteristic and provides much needed liquidity in the market place. The same must be said for the CDS market.

Unintended Consequences of Legislation

Comparisons have been offered between the effect the proposed legislation would have on the credit intermediation and risk transfer functions of the market and the effect the Trade Reporting and Compliance Engine (TRACE) regulation had on the secondary high yield bond market. These comparisons, I believe, are very instructive. When Congress mandated more transparency in the securities market it is unlikely that the impairment of the secondary high yield bond market was intended. However, that unintended consequence occurred and effectively ended the secondary high yield bond market as a viable market in which dealers, institutions and investors could participate. The deterioration of the secondary high yield bond market came about not a result of a "slowdown" in underwriting or other business cycle ripple effect, but as a result of new regulations that created the trade reporting mechanism.

How did this happen? The process for increased transparency in the secondary high yield bond market was the subject of great debate over a period of years. I was Chairman of the NASD's Bond Transparency Reporting Committee and this committee urged the NASD to rethink the extent to which such regulation would impact market viability. We offered detailed explanations as to why the transparency being mandated would lead to the impairment of that market. Our advice notwithstanding, the NASD adhered to the mandate for increased transparency and produced transparency in intimate detail. Further, the NASD then insisted that the detail of each trade, regardless of size, be published in such a short period of time after a trade was executed that the financial incentive for dealers and underwriters to participate was eliminated and the market dried up. Underwriters and dealers were no longer able to price in their capital risk, profit objectives and costs into these transactions and thus they dramatically reduced their participation in the secondary high yield bond market. The secondary high yield bond market has yet to recover.

Most of the offerings which were the subject of the secondary high yield bond market related to non-investment grade bonds. By all accounts this market was at least 50% of the total corporate bond market prior to TRACE. Investment grade offerings can be, and are, hedged in the government market because of their correlation. In the secondary high yield market, dealers cannot effectively hedge using government securities because the correlation between the two is too low. Since TRACE effectively eliminated the market making function traditionally performed by dealers, they were loath to undertake original issues of such non-investment grade offerings, because there would be limited distribution into the secondary market after the first trade was done and the street had access to the intimate details of the trade. Once the price was published on the first trade no one would lift an offer at a higher rate. Subsequently, the market has deteriorated.

Interestingly enough, the growth in the credit default market correlates to the deterioration of the secondary high yield bond market. Once the full effect of TRACE became apparent, in order for the dealers to try to maintain a dealer market, dealers looked to the CDS market as a hedge against their ability taking potions in the secondary cash high yield market. London has a very active and competitive CDS market and they would welcome regulation that would further inhibit the viability of the U.S. CDS market. Such regulation would facilitate the movement of this transportable market to any number of overseas markets, such as London, Hong Kong, Tokyo, Dubai, and others.

I offer these observations for an historical perspective on the law of intended consequences. I urge the Committee to examine in detail the effect that the proposed legislation will have on the CDS market and to reflect on the number of U.S. companies raising capital outside the United States in order to avoid the consequences of TRACE. Likewise, an increasing number of non U.S. companies have elected to delist from the U.S. equity markets because of the impact of Sarbanes-Oxley. London has taken the global leadership position as a venue for issuance of new equity and debt underwritings. By all accounts London will continue to occupy this global leadership position as more and more foreign corporation delist from the U.S. equity markets. In closing, I urge the Committee to carefully consider the potential impact of the proposed regulation on the continued viability of the United States as a leader in the global capital markets.

SUBMITTED LETTER OF STEVE MCDERMOTT, COO, ICAP

February 10, 2009

ICAP

The Honorable Collin Peterson
Chairman
House Committee on Agriculture
United States House of Representatives
1301 Longworth House Office Building
Washington, DC 20515

Dear Chairman Peterson:

Enclosed is a copy of statement that I am submitting on behalf of ICAP regarding draft legislation entitled, The Derivatives Markets Transparency and Accountability Act of 2009. Also enclosed is a white paper entitled, The Future of the OTC Markets, dated November 10, 2008, which was prepared by Mark Yallop, Group Chief Operating Officer, ICAP.

I respectfully request that both documents be included in the official record for the hearings conducted February 3rd and 4th on this matter.

Sincerely,

Steve McDermott
Chief Operating Officer
ICAP

ATTACHMENT 1

SUBMITTED STATEMENT OF CHRISTOPHER FERRERI, MANAGING DIRECTOR, HYBRID TRADING, ICAP

Proposed Derivatives Markets Transparency and Accountability Act of 2009

ICAP Comments as at 10 February 2009

ICAP would like to comment on a few specific aspects of the draft legislation entitled the Derivatives Markets Transparency and Accountability Act of 2009, which was recently distributed by the House Agriculture Committee and the subject of 2 days of hearings by the Committee on February 3rd and 4th.

About ICAP—Leading Broker in the OTC Markets

ICAP is a publicly held company traded on the London Stock Exchange (symbol "IAP"), has 4300 employees and maintains a strong presence in the three major financial markets—New York, London and Tokyo, together with a local presence in 30 other financial centers around the world. ICAP covers a broad range of "over the counter" (OTC) products and services in commodities, foreign exchange, interest rates, credit and equity markets as well as data commentary and indices. While ICAP does broker credit default swaps (CDS), it is a relatively small part of our overall OTC and exchange related business that intermediates $1.5 trillion in transactions between its clients each day.

ICAP is an Inter Dealer Broker whose sole objective is to bring together willing buyers and sellers to complete transactions and is the leading global broker in wholesale financial market. It sits at the crossroads of wholesale financial markets, facilitating the flow of liquidity in both the OTC and exchange transactions between commercial and investment banks and dealers representing companies, governments or other major financial customers around the world. ICAP also owns and operates a number of OTC trading platforms and post trade services and has a strong interest in the continuing health, efficiency and safe operation of the global wholesale financial markets.

Specific Comments on the Draft Legislation

ICAP wants to address two major aspects of the bill. We agree with the thrust of section 13 of the bill to require central clearing for credit default swaps *in lieu of* mandating that these instruments be traded exclusively through an exchange. It is vitally important to understand the differences between central clearing and mandated exchange trading. The Committee has heard testimony on the benefits and limitations of exchange-traded products and over the counter trading. It is our viewpoint that the two can, and do, successfully coexist. In fact, there are numerous examples in the OTC markets where centrally cleared trading is the standard by which other markets can be judged. The most liquid, actively traded securities globally, U.S. Treasury Bills, Notes and Bonds, trade just this way. There is substantive evidence of OTC markets that operate together with exchange-traded, complimentary products. References to transaction frequency and customized products in section 13 are vague and subjective and we would welcome the opportunity to help craft appropriate guidelines.

It the cases where a standardized futures contract can be designed to help hedge against the default of a borrower, those standardized contracts may attract sufficient liquidity to generate active open interest. In the event a more customized contract is necessary, the proposed exemptions should apply. There are examples in the markets where exchange-traded contracts and the underlying security co-exist and increase the overall liquidity of both products. In these markets, ICAP currently captures all transactions electronically and employs technology to automate trade reporting, affirmation and confirmation. It is important to note that market participants retain the ability to trade via multiple execution venues, encouraging competition and reducing costs, still, with access the same clearing pool. It would be very destructive to market efficiency and open competition to mandate a single place to trade assets, or to create a monopoly in trade execution and clearing.

ICAP respectfully submits reservations with the broad scope of section 16 and the limited space dedicated to this issue. To limit the access to this marketplace only to those who have a direct ownership of the underlying obligor by its very nature will eliminate the sellers in the marketplace as they are writing the protection to those holding the underlying. This limitation will essentially eliminate credit default swaps. The credit default swap market serves as the only market-based method of price discovery and liquidity for establishing a market value of a company's credit. This is the only place that market participants can place a value on a company's ability to service or repay a loan. Much has been written about the possible negative impact of a credit default swap; however the alternative is more opaque and subjective. We have seen the ratings agencies fail in their ability to properly predict and forecast the deterioration of the credit rating of a company and the procedures with which those agencies operate has been in question. The credit default market actually increases the transparency of the credit worthiness of an obligor and generates a market value for that credit ranking.

ICAP agrees with the Committee in the concept of clearing to increase transparency in financial reporting. The benefits of increased market transparency, automated post trade processes and availability of real-time market data will create the lion's share of the benefits to the credit default swap market and that limiting access to an exchange will essentially limit the benefits of the improvements. Fairness, transparency and suitable regulatory restraints will foster an environment that will help market participants better manage their risks and exposures.

The Context and Utility of OTC Markets

As an integral part of the OTC markets and the leading global Inter Dealer Broker, we felt it was important to comment at this early stage in the process to highlight the importance of the derivatives markets and the central role they play in risk management and economic growth. ICAP has significant expertise in the OTC markets and has deployed electronic trading systems for a number of products, including credit default swaps. Approximately 60% of our CDS trading in Europe is electronically traded with all live, executable prices posted on these systems. In the U.S., the sovereign CDS market trades in a hybrid voice/electronic model with all live executable prices posted for all market participants to see. The structure of the markets and the ways in which the Inter Dealer Broker operates help increase and simplify price discovery, trade execution, trade reporting and post trade processing. Our ability to respond quickly to the changing needs of a marketplace has been a trademark of our company. The OTC environment is already full of examples where execution is on "exchange-like" systems and which are already centrally cleared, with the attendant advantages of transparency and auditability. Not all parts of the OTC space can survive without IDB intermediation, nor can market participants take on the risk of buying and selling in extreme market conditions without having an anonymous means of "sounding out" the market. Even then, ICAP has been a long-time advocate of clearing and the utilization of a Central Counter Party model, more rapid trade confirmation and reconciliation, the elimination of reset risk, and portfolio compression (of which more consideration is given below). ICAP's businesses submit very large volumes of OTC transactions to DTCC (FICC, MBSCC and other related systems) and LCH.Clearnet on behalf of its customers on a daily basis.

It's critical that we avoid further constraining the flow of capital at a time when we should be encouraging its efficiency—particularly given the turmoil in the economy. Certain key assets, such as public debt, only trade in the OTC environment and such markets of course play a critical role in facilitating capital raising and providing financing that enable companies to operate, expand and provide employment for millions of Americans.

The OTC markets have developed in parallel to those markets traded on traditional stock, futures or commodities exchanges and the relationship between the traditional exchanges and the OTC market is more symbiotic than competitive. ICAP owns and operates a number of OTC trading platforms and integrated post trade services and understands this relationship. OTC and exchange markets each have separate, distinctive and logical reasons to exist—none of which are called into question by the recent market turmoil. Exchanges such as NYSE, NASDAQ, the London Stock Exchange and the CME Group—provide a trading platform for assets that are by their nature simple, in as much as they are all based on a single key measure (such as the anticipated financial performance of a company in the case of shares of stock or the value of a commodity at a time in the future in the case of exchange listed derivatives).

In contrast, the wholesale OTC markets offer a deep and liquid trading environment for professional market participants such as major banks, insurance companies and other financial institutions, to execute transactions, the key terms of which are individually negotiated, rather than standardized.

The OTC market has continually evolved over the last 25 years alongside the exchanges and serves a vital role in creating transparent credit and capital markets. Standard exchange-traded contracts very rarely provide a perfect hedge for actual economic risk and in fact can result in hundreds of variances to the original protection risk and increasing the frequency of trades. By contrast, users of the OTC markets can use non standardized financial products like credit default swaps or interest rate swaps to hedge their risk more precisely and transfer part of that risk to other professional OTC market participants.

Consider the following example of standard contracts used to manage risk. A contractor is bidding on the plumbing system in the Freedom Tower, a project that will last for nearly a decade. The contractor is required to quote a complete price for the project, and has to take into consideration what materials and labor will costs several years out. After a thorough review of the plans, and using his expertise, he determines that he will need the equivalent of 100,000 pounds of copper for the job. Clearly, if the price of copper should increase, he may not be able to meet his obligation. The simple financial hedge is to buy copper futures and include the cost of the futures in his estimate. So the contractor enters an order to hedge the cost of 100,000 pounds of copper to a specific date in the future and he's good to go—not quite. You see, the hedge was simply a financial hedge to lock in a specific prices of underlying metal at a specific point in time; but you can't use just the metal for plumbing. You need fittings, elbows, tees, drains, valves and all of the other specialized components of a plumbing system. The contractor doesn't have a complete hedge against an increase in manufacturing costs of these goods, a specific date when the goods will absolutely be needed, protection against a fall in the value of the U.S. dollar that would impact the costs of imported fittings, a hedge against an increase in shipping or trucking costs and so on. A prudent contractor might seek to have interest rate and potentially currency exchange rate protection over the life of the contract; this level of financial expertise would not typically be found in a plumbing company. Without the efficient operation of the wholesale segment of the market the cost of providing interest and/or currency rate insulation for the contractor would be substantially more difficult and expensive.

An Opportunity to Improve Regulation

While OTC markets have played a major role in global economic development and have been the hub of developments that benefit savers, investors, businesses and governments, we think their operation and effectiveness can be improved and ICAP favors changes to the regulatory framework supporting these wholesale financial markets. The challenge, of course, is for the regulation to be effective and limit any unintended consequences on the governmental entities, corporate and retail borrowers and investors that now rely on these markets. Specifically, the regulatory response to current events needs to focus on expanding and enhancing the transparency of the already existing OTC market infrastructure and making it more robust in those areas where it is too fragile. Regulations should mandate—as the New York Federal Reserve and others have been proposing—wider adoption of central counterparty (CCP) give up and or central clearing for OTC derivative markets. A Central Counter Party together with central clearing that is independent of the trading platforms and does not limit available sources of liquidity for those markets should be mandated for all markets.

The solution to current problems in financial markets also does not lie in attempting to mandate the transfer of OTC trading onto existing exchanges. OTC markets have traded, and need to continue to trade, separately from exchange markets for many reasons. OTC markets are both larger in scale and broader in scope than exchange markets and provide a vital risk management tool. An exchange solution also needlessly grants the exchange a monopoly on trade execution to a single vertical of trading, clearing and settlement, which limits competition and is usually accompanied by restricted access to clearing—which will lead to increased costs, increased risk and less flexibility for market participants. The OTC market has already invested significantly in developing its infrastructure for price discovery, trade execution and post trade automated processing which contributes hugely to reducing risk. but it needs to be further developed and better leveraged for the benefit of all.

ICAP has been an industry leader in developing solutions to reduce systemic and operational risk in the OTC markets, including the portfolio reconciliation and compression areas. TriOptima, a private company in which ICAP holds a minority interest, operates a global reconciliation and compression platform that has been in use for nearly a decade. Only through the prism of experience in servicing our markets can a clear vision of future improvements be seen. We have a history of innovation in an industry of innovation and would welcome the opportunity to broaden the knowledge of those charged with building a more robust regulatory environment.

Summary and Additional Reference Material

ICAP would like to thank the Committee again for this opportunity to comment on the proposed legislation to regulate certain aspects of the over the counter market. In addition to this statement, we would ask that a White Paper entitled, *The Future of the OTC Markets,* by Mark Yallop, Group Chief Operating Officer, ICAP, dated November 10, 2008 also be included in the hearing record. The paper goes into detail as to ICAP's positions on strengthening the OTC markets, but the key points that we believe can improve the way the OTC markets operate include a wider adoption of electronic trading; quicker settlement cycles; faster and automated trade confirmations; and greater use of netting and portfolio reconciliation and compression.

Thank you and we look forward to working with the Committee as this legislation moves through the House and hope you will use ICAP as a resource given our experience and the scope of our operations.

ATTACHMENT 2

ICAP

White Paper: The Future of the OTC Markets

10 November 2008

Mark Yallop
Group Chief Operating Officer
ICAP plc

ICAP WHITE PAPER
THE FUTURE OF THE OTC MARKETS

The global wholesale over the counter ("OTC") markets are critical to the effective functioning of the worldwide financial system. The vast majority of financial asset classes only exist in the OTC environment and consequently the efficient functioning of these markets is essential for the free flow and availability of capital, the mitigation of risk and investor choice. This paper assesses the current status of the trading, transaction processing and risk management infrastructure that supports the wholesale segment of the OTC markets and sets out some recommendations that we believe would improve the quality and robustness of this infrastructure.

1. SUMMARY OBSERVATIONS AND RECOMMENDATIONS

1.1. OTC markets have a crucial role to play in all national and international economies alongside and complementary to exchange markets. They have played a major role in global economic development and have been the hub of developments that benefit savers, investors, businesses and governments. The perception of OTC markets as "unregulated" overlooks that fact that all major market participants are individually regulated and codes of conduct are set by supervisors in many OTC markets. The OTC markets are not the root cause of current market problems (though the lack of transparency in some parts of the OTC world may have exacerbated some of the market reactions to current problems). OTC trading should and will continue to develop.

1.2. There is no doubt that an overhaul of some areas of the regulatory framework supporting wholesale financial markets is now necessary. In certain areas this overhaul may need to be extensive. But serious - and perhaps unintended and unfortunate - consequences may well follow if a wrong diagnosis of the problem is reached and/or the wrong actions are taken in response to the current market turmoil. The impact of these consequences would fall on many "bystanders" outside wholesale

OTC markets, including governments and corporate and retail borrowers and investors.

1.3. Specifically, the regulatory response to current events needs to focus on simplifying and enhancing the transparency of the already existing OTC market infrastructure and making this more robust in those areas where it is too fragile.

1.4. Regulations should mandate - as the New York Federal Reserve and others have been proposing - wider adoption of central counterparty ("CCP") give up and/or central clearing for OTC derivative markets. In those OTC markets that do not already operate a central counterparty, a CCP/clearing house that is independent of the trading platforms for those markets should be mandated.

1.5. The solution to current problems in financial markets does not lie in attempting to mandate the transfer of OTC trading onto exchanges. The OTC markets have traded, and need to continue to trade, separately from exchange markets for many reasons. OTC markets are both larger in scale than exchange markets and a vital risk management tool and as such their use benefits governments, corporations, investors and individuals worldwide. An exchange solution needlessly grants the exchange a monopoly on trade execution (which is usually accompanied by restricted access to clearing) which thereby leads to increased trading costs and risk and diminished flexibility.

1.6. The OTC market has already invested significantly in developing its infrastructure. This infrastructure does already contribute hugely to reducing risk but needs to be further developed and better leveraged for the benefit of all.

We believe that the following additional specific changes need be made in the way the OTC markets operate:

1.7. Wider adoption of electronic trading. Electronic trading creates greater price transparency, enables simpler and faster trade capture, affirmation and confirmation and easier supervision of trading activity. Electronic trading should be adopted for more OTC markets.

1.8. Quicker settlement cycles in all securities markets. A T+1 settlement cycle for all securities markets should be mandated.

1.9. Faster and automated affirmation/confirmation of all derivatives trades. The affirmation and confirmation of all OTC trades in all markets needs to be automated and accelerated as close as possible to the trade date.

1.10. Greater use of pre-booking netting. In many cases, transactions can legally and economically be netted, rather than settled on a gross basis. This should be mandated as it would materially reduce the operational and credit risks incurred by market participants.

1.11. Wider adoption of portfolio reconciliation. More regular and comprehensive reconciliation of OTC trade details and valuations between counterparties should be mandated.

1.12. Wider adoption of portfolio compression in derivatives markets. More regular and comprehensive compression of derivative portfolios, ideally on a multi-lateral basis, should be mandated to liberate capital and reduce risk.

1.13. These further improvements in the OTC markets and their infrastructure can be made relatively easily. Rather than rushing to develop new infrastructure, better and more extensive use should be made of the tremendous capabilities of the existing OTC market infrastructure, which has been battle tested and shown to operate very effectively, even at moments of severe market stress. The "turnkey" development of completely new market infrastructure is unnecessary and will require significant implementation time and incur a high level of risk.

1.14. These initiatives would deliver huge benefits for both buy and sell-side OTC market participants and "clean" data for regulators. They would materially reduce the operational, contingent credit and market risks that OTC market participants face; increase auditability and processing capacity of the existing OTC market infrastructure; severely reduce the need for continuing additional investment to meet the needs of growing markets; and materially reduce the costs incurred by market participants and improve their operating performance and return on capital.

2. INTERDEALER BROKERS AND ICAP

2.1. Interdealer brokers sit at the crossroads of wholesale financial markets, facilitating the flow of liquidity in both OTC and exchange transactions between commercial and investment banks and other major financial and non-financial institutions around the world. These deals may be transacted through traditional "voice" brokers, matching buyers and sellers on the phone, or through a variety of electronic trading platforms.

2.2. ICAP is the leading interdealer broker in the global wholesale markets. It is active in all of the OTC and many exchange traded fixed income, equity, FX, commodities and credit asset classes, in both cash and derivative form, across both developed and emerging markets. On behalf of its customers the firm transacts on average over US$1.5 trillion of volume each day. Its operations are connected to over 2,000 dealing rooms in 50 countries worldwide.

2.3. ICAP also owns and operates, outright or through equity stakes, a number of OTC trading platforms and post trade services businesses and has a strong interest in the continuing health, efficiency and safe operation of the global wholesale financial markets.

3. BACKGROUND ON OTC MARKETS

Development and Structure of OTC and Exchange Markets

3.1. The OTC markets have developed in parallel to those markets traded on traditional stock, futures or commodities exchanges. The relationship between the two is often portrayed as competitive, but is in reality more often symbiotic. OTC and exchange markets each have separate, distinctive and logical reasons to exist, none of which are called into question by the current market turmoil.

3.2. Exchanges – such as NYSE Euronext, NASDAQ, the London Stock Exchange, Eurex, CME Group – provide a trading venue for assets that are by their nature simple, in as much as they are all based on a single key measure or parameter (such as the anticipated financial performance of a company in the case of shares, or the value of a specific interest bearing bond or commodity at a time in the future in the case of exchange listed derivatives) and whose characteristics can be standardised. These markets, due to their "monolithic" structure, attract a wide range of participants who, by posting a modest amount of margin, trade standardised contracts in a single, deep and liquid marketplace. All exchange contracts are given up to a CCP/clearing house for settlement as discussed below.

3.3. In contrast, the wholesale OTC markets offer a deep and liquid trading venue for professional market participants, such as major banks and financial institutions, to execute transactions, the key terms of which are individually negotiated, rather than standardised. As such, it is no surprise that asset class innovation tends to originate within the OTC space. Some types of OTC asset class may over time become commoditised and migrate to the exchange environment; but this does not always happen. In OTC derivative markets, counterparties usually have bilateral arrangements in place to offset their contingent credit risk on each other by giving (or taking) collateral against that risk. In some of the more significant asset classes, OTC trades are either "given up" to a CCP or underwritten by a clearing house. As they have matured, several of the larger more homogeneous OTC markets have started to trade electronically as market players have recognised (as they have also on exchanges) the benefits of screen based trading.

<u>Central Counterparties and Clearing</u>

3.4. There is a crucial distinction between the functions of a <u>CCP</u> (which guarantees credit), a <u>clearing house</u> (which provides operational functions to risk manage, clear and settle trades) and an <u>exchange</u> (which provides an open all-to-all market for traders). Exchange organisations sometimes combine all three functions in one group of companies. <u>But CCP and clearing house functions do not have to be tied to exchanges or exchange products and these functions already provide valuable</u>

services to the OTC market, independently of an exchange, just as much they can as to the exchange traded market.

3.5. The key advantage of the CCP is that it acts as an intermediary, standing between the market participants on the two sides of a trade and guaranteeing the performance of each party to the other. The clearing house is in turn supported by capital posted by its members into a "default fund" that covers losses in the event of the default of one such member. In this way the CCP acts as a kind of "shock absorber" to the market in the event of the default of one or more market participants, allowing the net market impact of such an event to be managed with the least disruption. Recent events with the Lehman bankruptcy (and many earlier incidents) have proved that this approach works extremely well.

3.6. The key advantage of the clearing house is that it centralises all the operational functions that are otherwise duplicated by many market participants (thereby increasing efficiency and reducing risk) and imposes standardised processes for marking to market, posting collateral to immunise risk, payment and other functions (thereby increasing transparency and further reducing risk).

Size and Significance of the OTC markets

3.7. The rapid development of the OTC markets over the past 25 years has been well documented elsewhere. Academic advances from the late 1970s onwards, the development of the swap market in the early 1980s, advances in technology, changes in regulation, and the evolution of the asset management industry have all played an important part in the very rapid growth of OTC markets in many asset classes including foreign exchange, interest rates, credit, equities, energy, commodities and metals in both "developed" and "emerging" financial markets.

3.8. OTC markets have grown extraordinarily successfully and achieved such importance for two fundamental reasons.

3.9. First, the bespoke and individually negotiated nature of OTC contracts makes them much more attractive, and suitable, for hedging risk. Since exchange contracts are standardised and “real world” economic risk is normally non-standardised, traders who use exchanges for hedging purposes have to continue to live with the differential between their real underlying exposure and the payoff on their hedges. In short, exchange contracts very rarely provide a perfect hedge for actual economic risk. By contrast, users of the OTC markets can hedge their risk precisely and transfer to professional OTC market participants the residual risk they would otherwise be forced to live with if they had used an exchange product. Therefore, OTC contracts can hedge risk precisely.

3.10. It should also be understood that this point is not only an economic “risk” issue for those needing to hedge but also has important financial accounting consequences. Accounting standards set tests for “hedge accounting” that require very close matching of underlying risk with hedges for those hedges themselves to be allowed. These standards therefore oblige (for sound economic reasons) companies and other entities that are subject to them to use OTC markets rather than exchange products on most occasions.

3.11. Second, OTC markets do not suffer from the “information asymmetry” that is inevitable in exchange markets, where very experienced participants with access to very fast and accurate information participate alongside less experienced or knowledgeable participants who do not share that advantage. The relatively restricted range of participants in the wholesale segment of OTC markets – generally only major banks and financial institutions – makes a level playing field of “buyers” and “sellers” of comparable stature, armed with similar levels of expertise and information.

3.12. Effective markets require buyers and sellers to have confidence in each other – not only that transactions will be honoured once a contract is entered - but also that neither side is able to take advantage of the other as a result of access to better information. If this cannot be demonstrated buyers and sellers will not be persuaded to meet and create a market.

3.13. It is sometimes claimed that the wholesale OTC markets are inherently undesirable because they are only open to major, experienced firms. However, it should be remembered that this is the normal structure of all markets. In virtually every commodity or asset class a wholesale market exists alongside a retail market. The wholesale market exists to allow major participants to trade and lay off risk between themselves in bulk. The retail markets exist to allow smaller participants to trade and lay off risk in the much smaller and specific quantities and description that they need. It is no accident that it is normal for the two to co-exist alongside each other. Forcing either large market players to lay off risk in a retail market or small market participants to use the wholesale market creates much bigger risk than separating the two sets of players into complementary markets.

3.14. After two and a half decades of growth the wholesale OTC markets are very substantial. We estimate that on average about 2 million individual OTC trades (involving 4 million counterparty transactions); corresponding to about $5 trillion in size, occur each day across the range of FX, interest rate, credit, equity and commodity asset classes in both cash and derivative forms.

3.15. Despite the fall-out from the current financial crisis, whose root causes lie elsewhere, the development of the OTC markets has made a huge contribution to global risk mitigation in both that context and in economic growth over the past 25 years. It is important to distinguish between ineffective supervision of individual market participants and changes to, or regulation of, market structure itself. Innovations in risk management originating in the wholesale markets, including clearing, have had a profound and hugely beneficial effect on the way in which corporations, investment firms and governments manage their financial risks. The more efficient allocation of resources and freer flow of capital that they have allowed has dramatically increased predictability and stability in government, corporate and individual financial planning; and enabled much more rapid growth in the global economy, relative to what would have been achieved without them. The benefits derived by governments, corporations, investment management firms and individuals have been reflected in greater prosperity, choice and flexibility for these beneficiaries. The effects have been profound, right down to the level of many millions of individuals around the world and the way they manage their personal assets and liabilities and retirement funds. Accordingly, the consequences of any changes to the structure or operation of the OTC markets need to be very carefully considered.

Regulatory status of OTC and Exchange markets

3.16. The distinction is often made between “regulated” and “unregulated” markets, with exchange markets often presented as “regulated”, due to the fact that exchanges are mandated to regulate the content, behaviour and participation in specified products. However, the perception that OTC markets are unregulated is not true. In contrast to exchanges, the primary regulatory focus in OTC markets is on the participants themselves based on their activity, the nature of their counterparties and type of assets involved. Exchanges are recognised by a lead regulator and not very heavily scrutinised by other regulators on an on-going basis, while in contrast the OTC environment is complex, with multiple layers of overlapping and interlocking rules and governance. The settlement processes in FX are dictated and influenced by central banks; the settlement of government bonds is specified by the sovereign issuer; the size, scope and terms of bond issues are anyway set by the issuer, and are subject to transparency regulations; eligibility; settlement and default rules in a wider range of products are set by CCPs, clearing houses and central securities depositories; the Capital Requirements Directive extends not just prudential principles but also systems and controls requirements to all international parts of regulated groups that have EU headquarters; Automated Trading Systems and Multilateral Trading Facility regulations under MiFID and equivalent US and international regulations impose additional layers of regulation on electronic markets over and above the usual “regulated firm” rules that apply to their operators and participants, while in the derivative markets rules of operation, valuation and netting have been agreed by trade associations in conjunction with regulators – such as the Master Agreements published by the International Swaps and Derivatives Association (ISDA), the Securities Industry and Financial Markets Association (SIFMA), and the International Securities Lending Association (ISLA), all of which have been recognised by regulators, most importantly in the EU and US, as a valid basis for netting exposures for regulatory capital and risk reporting purposes. OTC market activity is also itself subject to extensive codes of conduct set by regulators such as the Bank of England’s NIPs Code in the UK, the multiple codes that have been created since MiFID, and international codes of best practice such as those produced by the foreign exchange trade association ACI. It may be tempting to regard the “regulated market” as the more robust model, but while exchange rules are certainly aimed at ensuring orderly markets, examples of inappropriate behaviour, operational failures and actual losses are found among market participants in both the exchange and the OTC world, suggesting that where failures do occur, these are the result of ineffective supervision of individual market participants as much as the market structure itself, whether exchange or OTC. Recent examples of significant failures in the exchange traded world include: the collapse of Barings in 1995 as a result of $1.3bn losses in exchange listed Japanese stock futures and options, Sumitomo's $2.5bn losses in copper futures in 1998, Liu Qibing's losses of up to $1bn in copper futures in 2005, Mizuho's loss also in 2005 of $250m in Japanese equity trading, Amaranth's $6.5bn loss in natural gas futures in 2006 and Societe Generale's $7.1bn loss on European stock index futures in 2007.

Current Market Disruption, OTC Markets and Regulation

3.17. We believe that the current market disruption is fundamentally a result of loss of confidence in financial reporting, specifically in relation to the valuation of certain types of mortgage backed securities, coupled with a systemic failure to practise prudent risk management. This impact of this loss of confidence has been hugely magnified because of the build up of leverage in the financial system in recent years, inadequate attention to liquidity management, a lack of transparency in reporting and management failure to understand balance sheet risk. Derivatives generally and credit derivatives in particular have received much abuse because they are perceived to have been the tool through which speculators have taken leveraged and uncontrolled bets on credit. This is despite the fact that they have been the vehicle through which banks have assisted mortgage providers and other corporations to reduce risk and hedge their cash flows and have helped market participants to mitigate credit risk exposures to bond issuers and other borrowers. Credit and other derivatives are in our view a symptom of the underlying problem rather than its cause.

3.18. Some have argued that OTC markets are inherently defective and that the current market turmoil illustrates the desirability of transferring trading onto the organised exchanges described above. While superficially appealing this argument misses – and will therefore fail to correct - the fundamental point that the market crisis is caused by a lack of confidence in financial reporting and by the actions of individual market participants – not by a lack of confidence in market structure or processing. No market structure – neither OTC nor exchange – can determine the correct price for (say) a 1 month unsecured inter-bank loan if there is material uncertainty about the repayment of that loan caused by overwhelming concern about the financial state of the borrower as evidenced by its financial reporting. Exchange trading does not solve this financial reporting issue and therefore it does not address or assist in solving the fundamental causes of the current market crisis.

3.19. Settlement through a CCP/clearing house (which is an entirely separate issue from trading on an exchange) can reduce risk for market participants and is a desirable development for OTC markets. As described above, CCPs provide transparency, can act as shock absorbers and have many risk management benefits.

3.20. There is no doubt that an overhaul of some areas of the regulatory framework supporting wholesale financial markets is now necessary. In certain areas this overhaul may need to be extensive. But serious - and perhaps unintended and unfortunate - consequences may well follow if a wrong diagnosis of the problem is reached and/or the wrong actions are taken in response to the current market turmoil. The impact of these consequences would fall on many "bystanders" outside wholesale OTC markets, including governments and corporate and retail borrowers and investors.

3.21. The regulatory response to current events need in our opinion to focus on simplifying and enhancing the transparency of the already existing OTC market infrastructure and making this more robust in those areas where it is insufficient.

4. OTC MARKET INFRASTRUCTURE

Overview of OTC Market Infrastructure

4.1. The infrastructure that supports wholesale OTC markets is extensive and costly – in large part due to the range and complexity of different asset types. We estimate that the operating costs of the transaction processing, risk management, settlement, clearing and accounting functions for wholesale OTC market participants to be about $12 billion annually. It employs many tens of thousands of people worldwide.

4.2. Huge advances have been made in improving the infrastructure that supports OTC markets over the past two decades, including: the development of standardised documentation within an enhanced legal framework by industry bodies such as the ISDA and the ISLA; the introduction of collateral support to mitigate counterparty risk; the development of robust payments mechanisms such as Real Time Gross Settlement (RTGS); and improvements in the clearing and settlement processes in many markets.

4.3. During the same period, a sophisticated array of services have been developed by a variety of organisations to improve the capacity and robustness of the OTC market infrastructure, including among others: Deriv/Serve and the Trade Information Warehouse operated by the DTCC, SWIFTNet Accord and SWIFTNet Affirmations operated by SWIFT, eConfirm and TZero operated by ICE, SwapClear and RepoClear operated by LCH.Clearnet, TriReduce and TriResolve operated by TriOptima, MarkitWire (formerly SwapsWire) operated by Markit and Harmony operated by Traiana.

4.4. Of particular benefit recently has been the work done by (a) the Committee on Payment and Settlement Processes ("CPSS") Working Group in 2006 with regard to deal confirmation and documentation, the use of collateral, the use of central counterparties in OTC markets, the implications of the growth of prime brokerage, unauthorised novations and derivative closeout processes and (b) the Counterparty Risk Management Policy Group (CRMPG II and III) on systemic risk mitigation, risk monitoring and management, documentation, accounting standards, and credit market infrastructure.

4.5. The OTC market continues to make very impressive progress in the upgrading of the robust infrastructure of its market as the following examples illustrate:

- about 80% of all trading in credit default swap indices and 50% of all trading in credit default swap single same derivatives in Europe is conducted electronically (with the associated auditability, STP and cost benefits). This compares to 0% just two years ago;

- about 74% of all credit default swap transactions and 68% of all interest rate derivative transactions are now backed by collateral. This compares to 30% in 2003;
- the time taken to process credit default swap trade confirmations has fallen by more than 75% since 2003;
- a significant proportion of wholesale interest rate swap transactions are now cleared through SwapClear; the oil derivative market is cleared through NYMEX Clearport or ICEClear; the EU emissions market is cleared through LCH.Clearnet, the European Repo market is cleared through RepoClear;
- safe payment processing is provided for nearly 60% of the OTC FX market through CLS;
- since the launch of its multilateral OTC derivative tear-up service in 2003, TriOptima has terminated 2.2 million OTC derivative transactions with an aggregate notional value of $63 trillion. In the first half of 2008 alone, TriOptima terminated over 800,000 transactions with an aggregate notional amount of $25 trillion and effectively <u>halved</u> the outstanding size of the index credit default swap market in just 6 months.
- since its launch in early 2007, the OTC derivative portfolio reconciliation service run by TriOptima has grown to provide weekly reconciliations on about 10 million individual derivatives transactions – corresponding to about 50% of the entire number of OTC transactions outstanding globally
- since its launch in 2006, the Harmony FX processing network provided by Traiana has grown to process over 150,000 FX transactions daily and materially alleviated infrastructure constraints in the rapidly growing FX prime broking industry

4.6. At times of market stress (e.g. the Asian and Russian market crises, the collapse of LTCM in 1999, collapse of Delphi in 2006, and banking and other defaults in 2008), the infrastructure serving the OTC markets has risen to the challenge of providing timely close-out of transactions and exposures for market participants. In October, for example, LCH Clearnet organised – with no market impact - the close out of $9,000bn of interest rate swaps in Lehman Brothers' portfolios following the bankruptcy of that firm. Nevertheless, a number of factors suggest that significant further effort should be directed to improving the quality of the infrastructure that supports OTC markets. These factors are explored in more detail below, but include:

- The rapid rate of growth of some OTC market volumes
- The inherently volatile nature of the prices of some OTC market instruments
- The capacity constraints on some OTC processing utilities and the back offices of some OTC market participants
- The inter-connectedness of some key market participants, e.g. those providing prime broking and clearing/settlement functions to other participants of the OTC markets

External Factors Influencing OTC market infrastructure

4.7. Four principal factors have, combined, had a significant impact on the post trade environment for OTC markets:

4.8. The growth of derivatives trading: the lower capital utilisation of derivatives makes them a more efficient and attractive medium for trading than cash markets for many market participants. For this reason, trading volumes in derivatives are frequently a multiple of volumes in the equivalent underlying cash markets. In comparison with the cash markets, OTC derivatives transactions create (a) more complex and longer-lived operational workload, (b) medium or long term contingent credit risk for participants on each other and (c) have slower trade affirmation/confirmation procedures that can create time delays between a transaction being executed and it being officially recognised in the books and records of each counterparty. Significant measures have been taken, and are being taken, by the industry to address these problems (e.g. the creation of MarkitWire and the development of the ISDA Collateral Support Annex). Nevertheless, all these issues have increased the complexity of the operational tasks facing OTC market participants and created significant capacity challenges for their back offices.

4.9. Growth of Electronic trading: Electronic trading is the logical end-state in the evolution of most OTC markets as commoditisation, competition and narrowing bid-ask spreads oblige market participants to find cheaper and more efficient execution channels for mature products. Electronic trading also greatly increases the transparency of price formation and market activity, which is a significant benefit. When electronic trading is introduced new trading techniques become possible, in particular algorithmic trading. This in turn drives steep volume growth and increasing ticket numbers, both of which add to the back office burdens of market participants.

4.10. Best Execution: Regulatory pressure for best execution (notably MiFID in Europe and Regulation NMS in the US) has fostered competition to provide the "best value" execution venues. The development of multiple execution venues (particularly in equities) has fragmented liquidity and increased ticket numbers. Unfortunately this has had the perverse (and presumably unintended) result of increasing the complexity of the settlement process and significantly increasing overall, fully loaded, trading costs.

4.11. Increasingly sophisticated investors: demographic change, the search for yield and focus on absolute returns have led to significant change in the asset management industry generally and rapid growth in the hedge fund industry in particular. This in turn has fostered rapid growth in prime broking; created a sub-set of market participants preferring to settle their derivatives trading through the payment/receipt of a simple financial (cash) transfer rather than by the traditional physical delivery/transfer of actual securities, commodities or other underlying assets; and development of derivatives markets in new asset classes. However, the infrastructure that supports prime broking is still new. Many OTC market settlement processes are set up to provide physical rather than cash settlement, and thereby unnecessarily increase operational and counterparty risk. And the infrastructure that supports OTC trading in newer asset classes is not as well established or robust as that for the older ones.

4.12. In summary, these external factors have in our view created the need for some further attention to be paid by the OTC industry to its infrastructure. The means to strengthen the infrastructure already exist. What is required is wider adoption, in a more concerted way, by more of the participants in the OTC market of the tools that already exist.

5. KEY CHANGES NEEDED IN OTC MARKET INFRASTRUCTURE

5.1. In summary, we believe that efforts to improve the quality and safety of the infrastructure that supports OTC markets should be focussed on the following key goals.

5.2. Wider adoption of electronic trading. Today the spot FX and major worldwide government bond markets all trade electronically. The benefits of electronic trading are numerous: price transparency is greater, trade capture is simpler and can be automated more easily, trade affirmation and confirmation are easier, regulatory reporting requirements are easier to fulfil. Electronic trading needs to be adopted by more OTC market participants for more markets than at present. Electronic trading of credit default swaps in North America and of interest rate swaps globally would be a major step forward for the industry.

5.3. Quicker settlement cycles in all securities markets. All significant OTC securities and repo markets worldwide are already cleared. However there is still wide variation in settlement time cycles. In some markets this process takes three working days (and hence up to five calendar days if a weekend intervenes). In others it is completed in one working day. We believe more resources should be devoted to achieving a T+1 settlement cycle for all securities markets. This effort will require more work by the respective central counterparties and clearing houses on their own infrastructures.

5.4. Faster and automated affirmation/confirmation of all derivatives trades. We concur with the goals of the CRMPG and wholeheartedly support the global regulatory push to speed up and automate the affirmation and confirmation of OTC trades as close as possible to trade date. At present this process still takes too long.

5.5. Greater use of net cash settlement. We believe that individual and systemic risk could be much reduced, and transparency increased, if there was a clearer distinction between transactions that genuinely require to be settled by the delivery/transfer of actual securities, commodities etc. and those that could be settled on a financial basis by the payment/receipt of a simple cash transfer representing the market value of the transaction. To support this objective, much greater use needs to be made in future of tools that already exist to facilitate the "netting" of transactions that are currently settled on a "gross" or "physical" basis.

5.6. Wider adoption of central counterparty give up and/or central clearing for OTC derivative markets. In those markets that do not already operate a central counterparty, introducing a CCP/clearing house for risk mutualisation and as a shock absorber would have many risk management benefits; provided that access to that CCP/clearing house is open to all execution venues on a level playing field. Vertical integration of CCP/clearing with a single execution venue (as happens on some exchanges) diminishes competition, increases costs and reduces flexibility. Greater use of CCP functions should also potentially facilitate further progress with portfolio reconciliation and compression and netting or transactions.

5.7. Wider adoption of portfolio reconciliation. Regular, or ideally continuous, reconciliation of trade biographical details and valuations between counterparties would greatly reduce operational risk by enabling market participants to be certain that their transaction records were truly accurate all the time. Technology to perform this function already exists (e.g. TriResolve) and should be more widely used.

5.8. Wider adoption of portfolio compression in derivatives markets. Because of the relatively long tenor of individual derivatives transactions, portfolios of derivatives grow quite large in size over time. Even though the real credit risk in a large portfolio is a fraction of the overall portfolio size, these large portfolios create increased operational risk. Normally it is possible to reduce materially the overall "size" of a portfolio of derivatives by "compressing" or "tearing up" transactions within the portfolio that naturally offset each other. Regular compression of derivative portfolios, ideally on a multi-lateral basis, reduces operational risk, credit risk and systemic risk (and thereby increases return on capital for market participants). Technology to perform this function already exists (TriReduce) and should be more widely used.

5.9. We believe that these further improvements in the OTC market infrastructure can be made relatively easily. Three points are fundamental:

- The solution does not lie in attempting to transfer OTC trading onto exchanges. The experience of previous attempts to move OTC market trading onto an exchange format has been very poor. In the past couple of years attempts to launch FX trading (FXMarketSpace) and credit default futures (on both CME and Eurex) have all failed to take hold. This is no accident. The majority of participants in the FX and CDS markets need the flexibility that OTC markets allow and cannot accept the standardisation that exchanges enforce. These and other OTC markets trade, and need to continue to trade, separately from exchange markets for all the reasons outlined in Section 3 above.

- Central counterparty mechanisms must be required to maintain open and fair access to all trading venues and participants wishing to use them. This is not just an issue of ensuring fair and open competition in trading – which is a fundamental point - but (equally importantly) of ensuring that the CCP/clearing house is actually adopted by the market. If CCP/clearing is "tied" to a particular trading venue, market participants will fear that that trading venue may abuse its economic power, to the disadvantage of traders, once its "tied" CCP/clearing house has acquired a critical mass of clearing business. This fear will in turn make market participants very reluctant to adopt such a CCP/clearing solution in the first place, thereby undermining the whole purpose. In this situation the market simply remains uncleared, participants live with the implicit inefficiency and cost, and the systemic benefits of the CCP/clearing house structure are lost.

- Rather than rushing to develop new infrastructure, better and more extensive use should be made of the tremendous capabilities of the existing OTC market infrastructure, which has been battle tested and shown to operate very effectively, even at moments of severe market stress.

5.10. We believe that multiple benefits would accrue from pursuing these initiatives for both buy and sell-side OTC market participants and for regulators. The economic self-interests of market participants are more closely aligned with the interests of market regulators than many at first assume. Apart from the specific merits mentioned in 5.2 – 5.8 above, pursuing these initiatives would:

- Materially reduce the operational, contingent credit and market risks that OTC market participants face as well as systemic risk
- Materially increase auditability and processing capacity of the existing OTC market infrastructure. Substantially reduce errors and opportunities for market abuses and the need for continuing additional and heavy investment to meet the needs of a growing market;
- Materially reduce the costs incurred by OTC market participants in processing transactions and improve their operating performance and return on capital.

ICAP plc
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