Statement Submitted on Behalf of the International Swaps and Derivatives Association, Inc.

February 13, 1997

Before the Senate Agriculture, Nutrition and Forestry Committee

The **International Swaps and Derivatives Association, Inc. ("ISDA")** appreciates the opportunity to present this written statement to the Senate Agriculture, Nutrition and Forestry Committee (the "Committee") in connection with the Committee's hearings held on February 13, 1997, and ISDA's oral testimony given in connection therewith.

ISDA is an international organization whose **membership comprises more than 300 of the world's largest commercial, merchant and investment banks and other corporations and institutions that conduct significant activities in swaps and other privately negotiated derivatives transactions.** Many of the issues addressed in the Committee's hearings regarding **reform of the Commodity Exchange Act (the "CEA")** are of great importance to ISDA and its members.

In addition to ISDA's members, many corporations, financial institutions and government entities in the United States rely on **swaps and other privately negotiated derivatives** transactions (**collectively, "swap transactions"**) to **manage the risks** associated with their financial and commercial activities. Such activities give rise to a host of risks, many of which could not be hedged or managed in an efficient manner, if at all, without the use of such transactions. Therefore, the availability of swap transactions at low cost and within a strong legal framework in the United States is of vital interest to all ISDA members and these other institutions. Any legal uncertainty presents a significant source of risk to individual institutions and to the financial markets as a whole, and precludes the full realization of the powerful benefits such transactions provide. **One of ISDA's main goals since its inception has been to promote legal certainty for swaps and other privately negotiated derivatives transactions.** ISDA has sought to establish (i) clarity about how swap transactions will be treated under U.S. law and laws in other jurisdictions, (ii) certainty that they will be legally enforceable and not subject to avoidance and (iii) certainty that key provisions in swap transactions (including termination and netting provisions) will be enforceable, even in the case of bankruptcy of one of the parties. In this regard, ISDA has developed standardized documentation, which is utilized by the vast majority of swap participants for their transactions.

ISDA has been particularly concerned with the legal uncertainties relating to the status of swap transactions under the CEA, and continues to believe that legislative measures should be taken to resolve these uncertainties. **Privately negotiated swaps and related off-exchange bilateral transactions serve important economic and risk management functions** and, due to the tailored nature of such transactions, differ substantially from the fungible exchange-traded futures contracts historically governed by the CEA. Nevertheless, and despite significant efforts by Congress, the **Commodity**

Futures Trading Commission (the "CFTC") and industry representatives, the inapplicability of the CEA to these transactions has not been fully and adequately clarified. The **recent introduction by Senators Lugar, Harkin and Leahy of the proposed Commodity Exchange Amendments Act of 1997 is a positive step** in this regard.

Derivatives, particularly privately negotiated swaps, are often misunderstood by the general public. **A swap is a powerful tool which allows the counterparties to adjust the risk characteristics of their assets and liabilities, fine tune their risk exposures and lower their costs of capital.** In such a transaction**, two counterparties establish a custom-tailored bilateral agreement to exchange cash flows** at periodic intervals during the life of the transaction according to a prearranged formula. These cash flows are determined by applying the prearranged formula to the "notional" principal amount of the swap. In most swaps, such as interest rate swaps, this notional amount never changes hands and is merely used as a reference for calculating the future cash flows.

For example, if a corporation has floating-rate debt outstanding and is concerned about its exposure to rising interest rates, it could use an interest rate swap to convert its floating-rate debt into a fixed-rate obligation. Similarly, if a corporation earns non-dollar revenues from a foreign subsidiary and wants to avoid the risk of fluctuating exchange rates, it could use a currency swap to hedge this exposure. Almost any kind of swap can be created. The **flexibility and benefits that swap transactions** provide have led to dramatic growth in the use of such transactions. Transactions take place around the globe, and U.S. institutions are leaders in the business at home and abroad.

I. Introduction to the Problems

The legal certainty of swap transactions has been undermined on several occasions in the past decade by the structure of the CEA, which (with certain exceptions) bans off-exchange "futures" contracts without defining the term. The statute has not easily accommodated the great innovations in financial products that have taken place since the enactment of the CEA. **In 1974, Congress excluded from the CEA certain wholesale privately negotiated transactions** that might otherwise have been thought to be futures. **However, at that time, swap transactions did not yet exist and therefore were not specifically excluded. The resulting legal uncertainties**, which will be explained in more detail below, **have inhibited the evolution of swap transactions in the United States** and the natural and beneficial growth in their use.

II. History of CEA's Application to Privately Negotiated Derivatives Transactions

In 1922, Congress enacted the original version of what is now the CEA to protect farmers and other producers and merchants of certain agricultural commodities from the perceived abuses of futures contracts. The protective scheme mandated that all trading of futures contracts on certain commodities be conducted on organized (and regulated) **futures exchanges** (the **"exchange trading requirement").** During the period from **1936 to 1974**, the **list of covered commodities was expanded** periodically.

The statute was **substantially revised in 1974** by (i) **establishing the CFTC to administer the CEA and regulate U.S. commodities exchanges**, (ii) **expanding the definition of "commodity"** to cover (with certain exceptions) "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt with"and (iii) **providing a statutory exclusion from the CEA** for "transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade" (the "Treasury Amendment").

In the **1980s**, the rapid growth in the use of innovative interest rate and currency swaps and related privately negotiated derivatives transactions to manage financial risk brought with it a **desire to ensure a clear and unambiguous legal status** for these transactions.

In **1987**, **these legal concerns were significantly heightened** when it was widely reported that the **CFTC** had commenced a formal **investigation** into the **commodity swap business of Chase Manhattan Bank.** Despite the fact that no enforcement action ever was commenced, these reports alone created significant uncertainty regarding the status of swaps under the CEA. It was **feared that swap transactions would be deemed to be illegal and unenforceable off-exchange futures contracts.** This uncertainty was **exacerbated when the CFTC issued an Advance Notice of Proposed Rulemaking** in which it effectively **stated that transactions such as swaps which include certain elements of futures contracts may be subject to the CEA**. In **response** to these concerns, large segments of **U.S. swap activity moved offshore**, and some U.S. firms ceased development of swaps entirely, reducing the ability of U.S. firms to manage risk and inhibiting the growth of these activities at U.S. institutions.

These actions **prompted ISDA and other industry participants to seek action by the CFTC to reduce the substantial legal uncertainty** which resulted from these developments. To address these concerns, in **1989** the **CFTC issued a policy statement (the "Swaps Policy Statement")** stating its view "that at this time **most swap** transactions, although possessing elements of futures or options contracts, are **not** appropriately **regulated as such under the [CEA]** and regulations [emphasis added]". **Thus, a nonexclusive "safe harbor" was extended by the CFTC to those swap transactions** that met a series of tests intended to distinguish them from their exchange-traded counterparts. However, the Swaps Policy Statement did not explicitly include interest rate option products. The application of the Swaps Policy Statement to interest rate caps, floors and collars was subsequently clarified in a series of no-action letters. However, **legal uncertainties** relating to the applicability of the CEA to swap transactions **remained**.

These uncertainties were further **heightened in 1990** as the result of a decision by a **United States District Court in New York in Transnor v. BP America Petroleum**, which **determined that contracts for future delivery of Brent blend crude oil constituted futures contracts and were therefore subject to the CEA**. Although swap transactions were not at issue in Transnor, it was feared that if another court were to

apply to swap transactions Transnor's limited view of the forward contract exclusion and its expansive definition of a futures contract, and at the same time were to ignore the Swaps Policy Statement, such a court might determine that certain swap transactions were futures contracts under the CEA. The importance and potential consequences of legal risks applicable to swap transactions were subsequently brought to light in 1991 when the London Borough of Hammersmith and Fulham, which had repudiated numerous losses from swap contracts, was able to convince the House of Lords (England's highest court) that it was ultra vires to have entered in the contracts in the first instance, thereby voiding the contracts. Concern increased that similar losses could be realized in the U.S. as a result of ambiguities under the CEA.

In **1992**, Congress took a major step by passing the **Futures Trading Practices Act of 1992** (the "**FTPA**"), which **provided the CFTC with the power to create exemptions** from the CEA for futures contracts and transactions with futures-like elements. The Report of the Committee of Conference of the U.S. House of Representatives and the U.S. Senate for the FTPA (the "Conference Report") stated that the intent of this authority was "to give the [CFTC] a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner". In passing the FTPA, **Congress specifically directed the CFTC to resolve legal** uncertainty concerns by promulgating an exemption for swaps and certain hybrid contracts. In order to avoid any implication that swaps are futures, Congress expressly noted in the Conference Report that the granting of an exemption does not "require any determination beforehand that the agreement, instrument or transaction for which an exemption is sought is subject to the [CEA]".

In response to the FTPA, the CFTC adopted an exemption for "swap agreements" in January 1993 (the "Swaps Exemption"). Reflecting Congress' direction in the FTPA, the CFTC did not make any determination that swap agreements would otherwise be subject to the CEA. **The Swaps Exemption exempted certain types of swap transactions,** when entered into by "eligible swap participants", from selected provisions of the CEA, including the exchange-trading requirement. Exempted transactions still must meet certain criteria that are intended to distinguish them from exchange-traded agreements. In general, the Swaps Exemption covers a broader range of swap transactions than does the Swaps Policy Statement.

As a result of the Swaps Exemption, even if a swap were found to be a futures contract, and none has, it would only be subject to (i) the market manipulation and anti-fraud provisions of the CEA and (ii) Section 2(a)(1)(B) of the CEA, which was enacted pursuant to the Futures Trading Act of 1982, otherwise known as the Shad-Johnson jurisdictional accord (the "Jurisdictional Accord"), and which (A) divides jurisdiction over exchange-traded equity derivative transactions between the Securities and Exchange Commission (the "SEC") and the CFTC, and (B) establishes that futures contracts on individual securities and certain securities indices are illegal.

Also in **January 1993, the CFTC adopted an exemptive framework for certain hybrid instruments (the "Hybrid Exemption"),** which provides an exemption for

instruments such as equity or debt securities or depository instruments with imbedded futures or commodity option characteristics. If applicable, the exemption extends to all provisions of the CEA except the provisions adopted pursuant to the Jurisdictional Accord. Other relevant exemptions which exist include those granted for (i) certain contracts for the deferred purchase or sale of specified energy products entered into between commercial participants meeting certain criteria and (ii) trade options sold to commercial counterparties who are entering into a transaction for purposes related to their business.

III. Importance of Swap Transactions

The importance of swap transactions to global commerce and finance has been well-documented. Careful tailoring of the nature, timing and amount of a transaction can insulate a swap participant from adverse movements in market prices, reduce its cost of capital or allow it to take a view on market changes. **Efficiency gains are created when risks are shifted to those best able to bear them.**

These useful transactions, as the Conference Report noted, "may contain some features similar to those of regulated exchange-traded products but are sufficiently different in their purpose, function, design or other characteristics that, as a matter of policy, traditional futures regulation and the limitation of trading to the floor of an exchange may be unnecessary to protect the public interest and may create an inappropriate burden on commerce". Section 3 of the CEA describes the necessity for regulation of "[t]ransactions in commodities . . . [that] are carried on in large volume by the public generally and by persons engaged in the business of buying and selling commodities and the . . . byproducts thereof in interstate commerce". Section 3 notes that such " . . . transactions and prices of commodities on such boards of trade are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed, to the detriment of the producer or the consumer . . . rendering regulation imperative for the protection of [interstate] commerce and the national public interest therein".

Several factors clearly differentiate swap transactions from the transactions regulated under the CEA. First, such transactions are **not "carried on in large volume by the public generally". Swap transactions are entered into on a customized, privately negotiated basis by sophisticated parties,** including governments and government-sponsored entities, commercial and investment banks, corporations, and, to a very limited extent, individuals. Second, **swap transactions are transactions in which each party assumes the credit risk of the other and thus each party requires specific knowledge about the other.** Unlike transactions on an exchange where parties may execute transactions anonymously, **swap participants require identifiable counterparties.** The limits set forth in the Swaps Exemption preclude transactions that are standardized and fungible, i.e., transactions that are capable of being traded in large volumes. In addition, since such transactions are not standardized and fungible, they are simply not capable of being systematically traded on the floor of an exchange.

The exemption of swap transactions from the CEA has achieved the objective of Congress, promoting economic and financial innovation and fair competition. As stated earlier, swap transactions are used today by a large variety of entities to manage financial risks and develop new opportunities to raise capital. The growth of swap activities has been fueled by demand from these entities for new structures and refinements to address their diverse needs and the ability of swap intermediaries to develop transactions which meet those needs efficiently.

IV. Legal Uncertainties

Despite the efforts referred to above and the related subsequent legislative and regulatory pronouncements, there continue to be concerns about the legal uncertainty with respect to the inapplicability of the CEA to swap transactions. The first stems from the very nature of the Swaps Exemption as an administrative pronouncement that can be revoked or modified by the CFTC; rendering swap transactions illegal except when traded on an organized exchange and enabling parties to privately negotiated derivatives transactions to seek to avoid their contractual obligations by asserting that the transactions are illegal off-exchange futures contracts. This could result in substantial losses to swap participants, including the loss of hedges which companies rely on to manage risk. Even the potential for such action could cause disruption to the financial markets.

Second, the various exemptions from the CEA applicable to swaps have stated that swaps are not "appropriately regulated" as futures under the CEA. But, they have not established with the force of statute that swaps are not futures. Therefore, problems could arise inadvertently, as the CFTC exercises its enforcement authority. The July 1995 enforcement proceeding against MG Refining and Marketing, Inc. and MG Futures, Inc. raised such concerns because the CFTC defined in such order "all the essential elements of a futures contract" in a way which was so broad as to encompass practically any privately negotiated cash-settled forward contract, including most swap transactions. The CFTC sought on two separate occasions to reassure key members of Congress and industry participants that its orders in these cases were not intended to, and did not, change the scope of the term "futures contract" under the CEA. **The need for the CFTC to take such actions highlights the fact that the current structure of the CEA is inadequate to provide the requisite degree of legal certainty to swap participants.** The mere risk that similar events may occur in the future may lead some to conclude that the United States lacks a sufficiently stable legal framework to continue to function as a center for privately negotiated derivatives transactions. In fact, the United States has become such a center as a result of the establishment of legal certainty with respect to other aspects of swap transactions, such as the enforceability of master agreement netting provisions in the case of insolvency of a U.S. counterparty.

The possibility that some or a substantial category of privately negotiated derivatives transactions may be interpreted, even inadvertently, to be futures contracts also raises serious concerns with respect to those transactions falling outside the scope of the Swaps Exemption, particularly equity swaps and other swaps based on the prices of securities. As discussed above, the CEA prohibits the entering into of futures contracts, unless made

on or subject to the rules of an approved futures exchange. Therefore, any financial transaction that is a futures contract must either be (i) transacted on an approved board of trade or (ii) exempted from the board of trade requirement by the CFTC. The CFTC has the power to exempt certain types of financial transactions from the requirements of the CEA under the FTPA, and promulgated the Swaps Exemption based on this authority. The FTPA, however, limits the exemptive authority of the CFTC by prohibiting the CFTC from exempting any futures contracts from the provisions of the Jurisdictional Accord.

Pursuant to the Jurisdictional Accord, the CFTC may not designate a board of trade for futures contracts on individual securities and certain securities indices, and since the CFTC can not issue an exemption for such transactions, such transactions are essentially illegal. The Jurisdictional Accord also divided jurisdiction over equity derivatives between the SEC and the CFTC; futures contracts based on a group or index of securities are treated like other futures contracts under the jurisdiction of the CFTC (i.e., they must be traded on an exchange) and jurisdiction over options on individual securities was granted exclusively to the SEC. As a result, the Swaps Exemption does not cover equity derivative transactions that are proscribed by the Jurisdictional Accord, and the conclusion that those transactions will not be regulated as futures must instead rest on the Swaps Policy Statement, which provides comfort that transactions within its limit are not "appropriately regulated" as futures contracts. To the extent, however, that swaps generally are deemed to be futures contracts, even inadvertently, (i) swaps on single securities and certain narrow indices or groups of securities would be rendered illegal under the Jurisdictional Accord and (ii) swaps on broad-based groups or indices would be required to be traded on an approved board of trade, which in each case would render a privately negotiated transaction pertaining to such securities, groups of securities or indices, as the case may be, subject to challenge by the parties to the transaction as unenforceable. Such risks have led many participants to enter into such equity derivatives transactions through off-shore affiliates.

The scope of the Treasury Amendment, which statutorily excludes certain foreign exchange and other transactions from the CEA, has also been the cause of legal uncertainty. The Treasury Amendment creates a statutory exclusion from the CEA for the transactions to which it applies, and therefore, unlike the Swaps Exemption, may not be revoked or modified by the CFTC. Without explicitly limiting its benefits to certain classes of participants, the **Treasury Amendment excludes from the scope of the CEA "transactions in foreign currency . . . unless such transactions involve the sale thereof for future delivery conducted on a board of trade".** However, due to **ambiguity** over the meaning **of the term "board of trade"** and the potential difference between transactions "in" foreign currency and transactions "involving" foreign currency, certain foreign exchange transactions, such as foreign exchange options, continue to give rise to potential **legal concerns**.

V. Discussion of Proposed Commodity Exchange Amendments Act of 1997

On **February 4, 1997, Senators Lugar, Harkin and Leahy introduced a bill (S. 257)** which attempts to **provide greater legal certainty as to the inapplicability of the CEA to certain transactions**, and to **reduce** in a prudent manner **regulatory burdens** imposed on the futures exchanges under the CEA. ISDA believes that the bill represents a constructive step forward in addressing each of these important issues. **We applaud the Committee's interest** in modernizing the CEA and welcome the opportunity to provide the Committee with suggested technical amendments to ensure that the bill achieves its intended purpose.

As described in more detail above, at present significant legal uncertainty remains as to the inapplicability of the CEA to swap transactions. In particular, the administrative nature of the Swaps Exemption and the Hybrid Exemption, and the inapplicability of such exemptions to certain transactions, like swaps based on securities prices, continue to raise concerns. ISDA welcomes the attempt in the bill to address these concerns.

A. Amendments Codifying the Swaps Exemption

Of great interest to ISDA are the provisions in **section 5** of the bill which provide for private transaction exemptions based upon the criteria contained in the existing Swaps Exemption and Hybrid Exemption. **ISDA supports the provisions and believes they contribute significantly to the reduction of legal uncertainty**, particularly with respect to swaps based on securities prices, which are currently excluded from the Swaps Exemption and Hybrid Exemption. The bill extends the same legal certainty to these transactions as is now available for other swaps and hybrid instruments. ISDA supports this further reduction of legal uncertainty.

In addition, we are pleased that the proposed new section 4(e)(1)-(3) of the CEA would apply generally to all privately negotiated derivative transactions qualifying for the exemption, which helps reduce concerns regarding the scope of the original administrative Swap Exemption. Also, we agree that the existence of an exemption should be a neutral event and should not create an inference that an exempted transaction was otherwise subject to the CEA. This helps to eliminate a possible inference that a transaction is a futures or option subject to CFTC jurisdiction if it does not meet the eligibility requirements for the exemption.

B. Treasury Amendment

ISDA also takes great interest in the provisions in **section 2** of the bill which are intended to **clarify the scope of the Treasury Amendment.** CFTC enforcement actions asserting jurisdiction over foreign currency derivative transactions have created significant interpretive issues as to the exclusion of Treasury Amendment instruments from CFTC jurisdiction. **This uncertainty will be reduced by language in the bill which clarifies that the Treasury Amendment applies to all off-exchange transactions "in" or "involving" foreign currency,** including currency options. ISDA supports this clarification.

ISDA has been and continues to be skeptical whether efforts to narrow the scope of the Treasury Amendment to expand the CFTC's jurisdiction can be accomplished in a manner that promotes legal certainty for all swap transactions without unduly increasing regulatory burdens. ISDA is concerned that, if enacted in its current form, section 2 of the bill may have implications for the applicability of the CEA to other privately negotiated derivatives transactions. In addition, section 2 of the bill, as currently drafted, would make transactions in or involving foreign currency by unsupervised entities with the retail public, if found to be futures, illegal and unenforceable because of the bill's application of the CEA's exchange trading requirement to such transactions.

We are also concerned about some of the specific language used in section 2. For example, the use of the term "shall include" in the definition of "board of trade" applicable to foreign currency transactions leaves open the possibility that the statute could be construed to apply to organizations other than those included in the definition provided in the statute. In addition, the bill does not define "general public" or "unsupervised entities", as such terms are used in section 2, and leaves the drawing of these important jurisdictional boundaries unresolved. By not defining these terms, the language of the bill could contribute to the same kind of legal uncertainty that has been raised in litigation as to the scope of the existing Treasury Amendment.

ISDA takes note of the recent proposal of the Treasury Department to amend the Treasury Amendment to provide adequate protection of retail participants while achieving legal certainty for derivatives in foreign currency and government securities, as well as the other enumerated instruments. ISDA especially applauds the Treasury Department's view that consideration must be given to expanding the list of enumerated instruments to reflect the expansion in the variety of financial transactions since 1974, and the significance of certain products to investors. We would welcome the opportunity to continue to work with the Committee and the Treasury Department on this expansion of the Treasury Amendment to cover all types of privately negotiated derivatives transactions and to ensure that all other changes to the Treasury Amendment, if ultimately enacted, promote legal certainty.

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ISDA appreciates this opportunity to express its views regarding these important issues, and looks forward to continued discussions with interested parties, including members of the Committee and their staffs, industry participants and financial regulatory bodies, including the CFTC, with a view towards crafting constructive solutions that offer greater legal certainty concerning the inapplicability of the CEA to swap transactions. If you should have any questions or comments, please feel free to contact the undersigned, or any members of the ISDA Board of Directors listed in Annex A.

CONSOLIDATED TESTIMONY
OF THE FUTURES EXCHANGES OF THE UNITED STATES
BEFORE THE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
UNITED STATES SENATE

FEBRUARY 11, 1997

Chairman Lugar and members of the Committee, this statement is submitted on behalf of the following futures exchanges ("the Exchanges"). They transact all of the regulated futures business in this country.

Chicago Board of Trade MidAmerica Commodity Exchange
Chicago Mercantile Exchange
International Monetary Market Index and Options Market
Coffee, Sugar and Cocoa Exchange Inc.
Kansas City Board of Trade
Minneapolis Grain Exchange
New York Cotton Exchange
Citrus Associates
New York Futures Exchange, Inc.
New York Mercantile Exchange Commodity Exchange

The Exchanges are pleased to submit this joint written testimony on S. 257. While each exchange has specific areas of concern and emphasis, we agree on one thing -- S. 257 represents a fundamental shift in regulation of our markets and offers us a choice to compete with the over-the-counter dealer markets and foreign exchanges on a playing field that is more level than we have ever enjoyed. Chairman Lugar, Senator Harkin and **Senator Leahy are to be commended for their creative solutions** to some of the thorniest issues our industry has faced in over 20 years.

S. 257 responds to a simple competitive fact of life -- consumers of risk management services have choices and consumers often choose to acquire services and products based on cost considerations. U.S. futures markets have found it increasingly difficult to compete with foreign exchanges and OTC dealers as our competition's regulatory costs have diminished or remained virtually non-existent while ours have escalated. Regulatory cost -- not the quality of our services and products -- has handicapped our industry and crippled its growth and innovation in recent years. Competing markets are not so burdened.

Headlines: "Swaps Buoyant' as Exchanges Stagnate" [Financial Products, February 11, 1996] and "Futures Trading Slackens" [Financial Times, January 31, 1997] proclaim the problem. The Bank for International Settlements' (BIS) 1995 Central Bank survey of derivatives activity provides the best apples-to-apples snapshot comparison between the size of the OTC and exchange-traded derivatives markets. Gross amounts outstanding in the OTC market was $63.7 billion while the exchange-traded market was only one quarter of that -- $16.3 billion. That the OTC market is four times the size of the

exchange-traded market is not a surprise. The growth rate over the past five years for the swaps market has exceeded 500%, dwarfing the 54% growth rate of CBOT Treasury bond futures. This also stands in stark contrast to the 23.5% trading volume decline in the CME currency contracts over the past two years. During that same period, average daily turnover in the much larger OTC foreign exchange market increased by 43.2%.

In recognition of this precarious situation, all of the futures exchanges in the U.S. agreed last year to forge a united position on Commodity Exchange Act reform. This challenging and historic effort was first completed last June for this Committee's hearing. The Exchanges have reached a consensus again for today's hearing on S. 257. This joint testimony demonstrates the depth of commitment on the part of all the Exchanges to fight for the industry's survival in today's increasingly competitive environment.

The viability of U.S. futures exchanges is in serious jeopardy. By re-examining the basic premises of the existing regulatory scheme and identifying regulatory disparities between exchange-traded and over-the-counter risk-shifting products, S. 257 begins the process of arresting the dangerous trends threatening that viability.

The Exchanges are providing specific comments on each area covered in S. 257. We look forward to working with the Committee and its excellent staff to improve and enact S. 257 as soon as possible.

TREASURY AMENDMENT (Section 2)

The exchange community applauds the leadership of Chairman Lugar and Senators Harkin and Leahy in including in section 2 of S. 257 language to address the unregulated offering by bucket shops of foreign currency futures to retail investors. Section 2 supports the principle that all retail investors in currency products need protections against fraud and abusive practices.

As we discussed in our testimony last June, the "Treasury Amendment" has created numerous interpretive and legal problems since its hasty enactment in 1974.

The problem was exacerbated as recently as October 30, 1996, when the United States Court of Appeals for the Ninth Circuit interpreted the Treasury Amendment to permit bucket shops to sell futures contracts to members of the general public without any form of federal regulation (CFTC v. Frankwell Bullion).

On November 13, 1996, the Supreme Court heard oral arguments in the case of CFTC v. Dunn. If the Supreme Court rules as many organizations urged it to, it would provide bucket shops selling futures and options in a wide range of products absolute immunity from federal regulation, in stark contrast to the panoply of customer protections and regulatory oversight provided on the regulated futures exchanges.

The inclusion of a Treasury amendment "fix" in section 2 of the bill acts as evidence of the Committee leadership's recognition that this matter needs a prompt legislative

solution. Importantly, the bill will clarify that the CFTC has jurisdiction over bucket shops that market foreign currency futures to retail investors. And the bill recognizes that any market -- OTC or exchange -- where the general public does not trade does not need the heavy federal regulatory hand of the CFTC. In this regard, we are concerned that the bill does not contain a statutory definition of either "general public" or the term "retail investor". In light of the litigious history of this Amendment, the Committee should adopt a specific, fair definition of these terms.

In addition, there is room for further improvement in the Treasury Amendment to remove any discrimination against exchanges in the offer and sale of Treasury Amendment products to retail investors. Section 2 provides that under the Treasury Amendment every kind of non-exchange entity may offer currency products to retail investors, so long as the entity is subject to some undefined form of supervision. Securities broker-dealers would also be allowed to sell government securities transactions to the retail public under the exclusion.

The absence of parity in customer protections is significant. While banks and broker-dealers are subject to a level of federal supervision or regulation, they do not provide safeguards comparable to the exchange trading environment. In short, these CEA-excluded OTC transactions with retail investors will not be subject to the same degree of oversight as they would if they occur on an exchange.

We do not believe it would be prudent or fair to allow banks and broker-dealers to offer currency and government security futures to retail investors under the Treasury Amendment's exclusion. This Committee and Congress are on record as to the importance of the entire system of protections for unsophisticated retail investors in futures transactions, beginning with the account opening process, through fair pricing and execution, stringent audit trail, segregation of funds, and self-regulatory policing. To our knowledge, no one has come forward to argue that retail currency and government security futures customers are less deserving of these protections than are other retail futures customers. The proposal in section 2 of the bill to excuse from the Commodity Exchange Act even unregulated public customer currency futures transactions by "supervised" entities should not be enacted unadvisedly. We urge the Committee to carefully review these aspects of section 2 and to determine whether any public policy grounds support the disparate treatment of retail customers in exchange and OTC transactions.

HEDGING (Section 3)

By deleting the phrase "through fluctuations in price" from the statutory purposes in section 3 of the CEA, S. 257 takes an important first step toward recognizing today's prevailing market view that hedging encompasses more than just price risk. This change also accommodates both innovative new instruments that expand the range of risks which may be hedged as well as evolving strategies for managing those risks.

While this change is welcome, it is only a beginning. As Congress reviews and

reconsiders fundamental questions of regulatory policy covered in the Act, the exchanges agree with Senator Lugar that renewed consideration should be given to spelling out the appropriate purposes served by CEA regulation for the modern markets of today as well as those of the 21st century. The existing section 3 is based on outmoded and flawed economic thinking, questionable factual background and markets that reflected primarily localized concerns. It should be rewritten to reflect the reality of today's global market needs and customer base. Representative Tom Ewing's bill, H.R. 467, offers a sound model for restating the CEA's purposes for today's markets.

DELIVERY POINTS FOR FOREIGN FUTURES CONTRACTS (Section 4)

The Exchanges are pleased that the sponsors have recognized the "systemic risk" to United States producers, processors and consumers that can occur when foreign contracts for commodities for future delivery in the United States are marketed and sold here, subject to neither the oversight of the CFTC nor to the Commodity Exchange Act. The problems associated with the Sumitomo affair highlighted the risk to commodity pricing presented by this loophole in the statute. In the circumstances related to Sumitomo, the copper industry traded futures on the COMEX in New York and on the London Metal Exchange (LME), based in London. Copper for future delivery traded on the COMEX was deliverable in COMEX-approved warehouses across the United States. Copper for future delivery traded on the LME was also deliverable in the United States, at warehouses virtually across the street from the COMEX-approved warehouses. Market surveillance under the U.S. regime provided information on the amount and ownership of metal in the COMEX warehouses, the futures positions of large traders on COMEX, the cash copper positions of large traders on COMEX, and the hedging or speculative intentions of those traders. Parallel information was not available for LME transactions.

Section 4 of S. 257 simply does not go far enough to address these risks. Proposed Section 4(b)(2) of the Act mandates that the CFTC "consult" and "endeavor to secure adequate assurances" that a foreign futures contract with a U.S. delivery point "will not create the potential for manipulation of the price, or any other disruption in trading" of a U.S. commodity or futures contract. It does not empower the CFTC to do anything at all if the foreign regulator declines to consult with it, or if despite its best efforts, it is unable to secure "adequate assurances." Thus, it recognizes the problem, yet offers no real remedy. It puts the CFTC, producers, processors, consumers, the Exchanges and the financial community in the perilous position of determining that there exists a potential for manipulation of domestic commodity prices without having any authority to take action.

PRIVATE MARKET, HYBRID AND PROFESSIONAL MARKET EXEMPTIONS (Sections 5 and 6)

Background

The exchange community was very disappointed with the Commission's response to the enactment in 1992 of the exemptive authority under section 4(c) of the Commodity

Exchange Act. In the Conference Report to the Futures Trading Practices Act of 1992, the Conferees directed the Commission to apply "fair and even-handed" treatment when considering exemptive relief for over-the-counter and exchange-traded markets. [H.R. Rep. No. 102-978, 102d Cong., 2d Sess. 78 (1992).] Based on that admonition and the Commission's statutory mandate to use its exemptive powers to promote "fair competition," U.S. futures exchanges expected to receive equal treatment when the Commission considered exemptive relief for the exchanges' competitors in the OTC dealer markets. Indeed, as the 1992 law was being enacted, the CFTC proclaimed the new statute's exemptive provisions "will give the exchanges the chance to compete head-to-head with other derivatives markets." [CFTC News Release No. 3583-92, (October 29, 1992).]

The promised equality of treatment for exchange and OTC markets vanished soon after the 1992 legislation became law. The Commission decided to grant broad regulatory exemptions allowing our competitors in the over-the-counter markets to engage in certain swaps, hybrids, and energy contracts and transactions exempt from the regulatory oversight of the Commission. The Exchanges also asked to be allowed to offer those exempt products. The Commission denied those requests. A number of exchanges then petitioned the Commission for narrower exemptive relief under section 4(c), submitting specific exemptive applications -- ProMarket and Rolling Spot -- in an attempt to obtain somewhat similar relief for exchange markets that the Commission had granted to OTC markets. Again, the Commission denied the exchanges' request. Instead, the Commission adopted its Part 36 rules, grudgingly granting such meager exemptive relief that no exchange has attempted to list a product under Part 36. The result: the Commission has yet to provide the exchange community with the "fair and even-handed" treatment intended by the conferees who considered the Futures Trading Practices Act of 1992.

Section 5 - Exemption Authorities

We are sympathetic to the desire of dealers in the over-the-counter swaps community to codify the current regulatory exemption granted them by the CFTC. We do not oppose the codification of the current exemption for swaps and hybrids.

However, any such "codification" should be carefully crafted by the Committee so that it does not expand the existing disparity between over-the-counter and exchange markets. For example, we agree with the position of the authors of the bill, as stated in the summary accompanying the bill, that no mutualized risk clearing system should qualify for the exemption. That position should be clearly codified. It is consistent with the Commission's intent in adopting the creditworthiness condition of the swaps exemption so that the exemption would not extend to transactions "where the credit risk of individual members of the system to each other in a transaction to which each counterparty is effectively eliminated and replaced by a system of mutualized risk of loss that binds members generally whether or not they are counterparties to the original transaction." [Federal Register, January 22, 1993, at page 5591.]

Similarly, the Committee should clarify in the statute that the exemption, in prohibiting

the use of a "multilateral trade execution facility", does not extend to the use of exchange-like or electronic trade execution systems such as those operated by the New York Stock Exchange, the Chicago Board Options Exchange, the NASDAQ, or proprietary electronic trading systems.

In addition, it is of concern to the exchange community that section 5 of the bill will broaden the current swaps exemption to allow for over-the-counter trading in equity swaps without providing the same relief to the exchange community. This will result in precisely the disparate regulatory treatment between regulated exchanges and the over-the-counter community that other provisions in the bill seek to redress. In fact, the bill provides no relief at all to futures exchanges wishing to offer equity products to their customers. Restrictions on the classes of equity products that can be offered by futures exchanges are not relaxed. The cumbersome, overlapping review requirements of both the Commission and the Securities and Exchange Commission will continue to seriously delay the ability of exchanges to innovate.

Section 6 - Exemption for Professional Markets

In granting the swaps and energy exemptions, the Commission embraced an important principle from the 1992 legislation. For the first time in the history of the Commodity Exchange Act, Congress recognized explicitly that futures contracts could be lawfully traded on a market that was not a designated contract market subject to CFTC regulation if, but only if, that market received a CFTC exemption and was not available to retail public customers. [7 U.S.C. 6(c)(2) and (3).] Congress established therefore that the CFTC could exempt from any and all regulation under the Commodity Exchange Act "professionals only" markets in futures contracts.

The CFTC decided to exercise that authority, but only for OTC markets, in its swaps and energy exemptions. The CFTC proclaimed that limiting the exemptions to only institutions and professional traders called "appropriate persons" "addressed concerns regarding financial integrity and customer protection" and ensured that exempt transactions would "be limited to sophisticated entities . . . who are financially able to bear the risks associated with such transactions." [58 Fed. Reg. 21286 (April 20, 1993). See also 58 Fed. Reg. 5592 (Jan. 22, 1993).] Significantly, the CFTC decided to exempt those "professionals only" transactions even if neither party to the trade was otherwise regulated. Thus, according to the Commission, transactions among institutions and other professional traders need no CFTC or other federal trading regulation.

That policy was not followed by the Commission in connection with exemptive relief for exchanges. The Commission refused to extend exemptive relief to exchange markets even if limited to professional traders only, claiming the professional exchange markets still needed CFTC regulation. That anomalous Commission policy was recently reconfirmed in Chairperson Brooksley Born's December 26,1996, letter to Senator Lugar. As a result, the exchanges recognize that if they are to receive "fair and even-handed" exemptive treatment, they must look to Congress for action.

A Sensible ProMarket Exemption

Section 6 of S. 257 contains exemptive relief for exchange markets that begins to make good on the promise of the 1992 legislation. Subject to certain limitations, a futures exchange may sponsor markets limited to institutions and trading professionals and be subject to streamlined Commission regulation. Core powers of current law -- fraud, manipulation and emergency provisions -- would still be available to the Commission with respect to professional markets. Otherwise self-policing by the exchanges would be relied upon in these markets.

Section 6 thereby affords exchanges an opportunity to innovate with respect to trading products and self-regulatory mechanisms without jeopardizing traditional markets and small retail traders in any way. This ProMarket exemption moves exchanges a long way toward achieving a regulatory balance with OTC markets. If this exemption becomes law, the Exchanges may begin to compete for that risk management business which in recent years has shied away from exchange markets due to federal regulatory inflexibility and costs. Market users will make their choices on the basis of the merits of the trading market and not regulatory arbitrage. That will make U.S. exchange markets stronger and more agile in our continuing efforts to respond to the needs of a rapidly changing business world.

Unfair and Unsound Limitations on Innovation

Today, agricultural and financial businesses as well as other enterprises with risk management needs are looking to manage risks in more ways than ever before. Certainly, the Freedom to Farm Act sparked many innovative and creative approaches to managing those agricultural risks that government had traditionally shouldered. In the financial world, OTC dealers and foreign exchanges are offering new and exciting products based on equity security prices, including single stock futures which are banned in the U.S. under the Shad-Johnson Accord.

The Exchanges too want to participate in and enhance those new markets and market opportunities. Unfortunately, S. 257's ProMarket provision would stymie those innovative efforts in two ways. First, ProMarkets would be unable to offer any products involving agricultural commodities, including any new agricultural instruments that are based on crop yields and other innovative measures. Second, ProMarket products would not be exempt from the Shad-Johnson Accord prohibitions. In addition, the language in new CEA 4(f)(2)(B)(i) is ambiguous as to whether any existing contract market limited to professional traders may qualify under the exemption. That limitation would be unduly restrictive and should be deleted from this bill.

These limitations are unfair and unsound. They are unfair because OTC transactions are not so limited; in both areas, the bill's so-called Private Transaction Exemption allows OTC dealers to offer the same products exchanges operating ProMarkets would be barred from trading. That kind of discrimination against exchanges is precisely what S. 257 was intended to correct. No basis exists to allow crop yield or single stock futures contracts to

be traded over-the-counter in professional markets, while those same instruments are precluded on ProMarkets. The limitations are unwise because exchange markets offer safeguards that are unavailable on OTC markets. Exchanges have open and competitive trading, transparent pricing, margining, mark-to-market, tested and effective self-regulatory standards and the unparalleled financial integrity of clearing. ProMarkets with those characteristics should not be considered off-limits for any new innovative products, particularly where only professionals will be trading on those markets and Congress and the CFTC have recognized that those traders do not need traditional federal protections. The Exchanges urge the Committee to revise S. 257 to allow exchanges the right to compete in these important areas.

One further limitation addressed indirectly in the bill is agricultural trade options. The Commission's regulations now ban OTC agricultural trade options, but the CFTC is actively considering lifting that ban. If the ban is lifted on the condition that each dealer of agricultural trade options replicates the risk of any such transaction with a corresponding trade on a CFTC-designated contract market, exchanges would be able to provide additional financial security, indirectly, to this new product innovation. In addition, the replication condition would foster greater risk assessment and financial integrity capabilities for both exchange and OTC markets. But if the Commission lifts the trade options ban without a replication condition, the financial integrity of those OTC transactions would be undermined. The Exchanges urge the Committee to consider the agricultural trade options ban in its further deliberations.

Exchanges Do Not Pose Greater Risks than OTC Markets

The CFTC opposes granting ProMarket relief to exchanges claiming that exchange professional markets need federal regulation, while professional OTC markets do not. The Exchanges emphatically disagree with the Commission's conclusion. Ironically, it is contradicted by many prior policy positions the agency itself has adopted. Let's examine the record.

In 1987, the Commission accurately described the reasons why exchange markets are safer than OTC trading.

"[Exchange] markets provide safeguards to participants in futures and commodity options transactions, including open and competitive trading, public price dissemination, and protection against counterparty credit risk, that are not generally available other than on exchange markets."

[52 Fed. Reg. 47022 (Dec. 11, 1987).] More recently, the CFTC observed that exchange markets offer protections that market users may find "preferable to off-exchange transactions where prices are often opaque and credit risk is a more profound issue." [59 Fed. Reg. 54139, 54143 (Oct. 28, 1994).]

Clearing

In direct contradiction of its prior findings, the Commission now claims that the existence of an exchange clearing system -- which is uniformly praised as a mechanism for eliminating counterparty credit risks -- makes exchange trading riskier than OTC trading and hence compels regulation of exchange trading. If that were true (which it is not), what would happen if an exchange proposed to trade a new futures contract without any clearing system? If the CFTC is right that clearing is so inherently risky that government must oversee its operations, one would expect the CFTC to applaud non-cleared futures and allow trading to commence. For over 20 years, however, the CFTC has mandated that futures exchanges must provide a clearing system for all new futures contracts in order to remove counterparty credit risk. In 1976, the Commission concluded that any futures contract not "secured through a clearing system would be contrary to the public interest." [41 Fed. Reg. 40093 (Sept. 17, 1976).] As a result, the CFTC's "self-fulfilling" policy now is as follows:

In order to trade futures, the CFTC requires an exchange to have a clearing system and, according to the CFTC, exchanges must be regulated because they have a clearing system.

That kind of "heads I win, tails you lose" posture is no basis for making regulatory policy.

Despite requiring exchanges to use clearing systems, the CFTC now claims that exchange clearing mechanisms dangerously "concentrate within one institution credit risks that otherwise would be diffused throughout the market," while the unregulated OTC markets present no comparable risk. [Letter to Senator Richard G. Lugar, Chairman, Senate Committee on Agriculture, Nutrition and Forestry from Brooksley Born, CFTC Chairperson, 4 (Dec. 31, 1996).] But only three years ago the Commission complained that "a commonly voiced concern associated with the OTC derivatives market as a whole is that risks may have become highly concentrated in a small number of participants which may include non-bank unregulated financial intermediaries." [CFTC, OTC Derivatives Markets and Their Regulation, 114 (October 1993).] Moreover, the CFTC observed that "such dealers, [when] they stand between matching transactions as counterparties in both transactions, resemble individualized clearing organizations." [Id.] The CFTC's December 31, 1996, letter makes no effort to reconcile its late 1996 conclusions with its findings of just a few years earlier.

In any event, the Commission's central policy concern is misplaced -- a mutualized risk, exchange-style clearing system does not concentrate risks as the CFTC now claims. Instead the clearinghouse members underwrite each other's credit risk through the clearing system, thereby diffusing that risk, as the Commission knows quite well. That is why the Commission has, in the past, observed that exchange clearing provides safeguards for trades which the OTC derivatives markets lack. Why the Commission now is reversing field is puzzling at best.

Open and Public Pricing

The Commission's other claim -- that the price discovery and price basing features of exchanges justify regulation of only exchanges -- is similarly untenable. In the first place, the Commission has cited both "open competitive trading" and "public price dissemination" as, to use the Commission's own words, "safeguards" provided by exchanges "that are not generally available other than on exchange markets." [52 Fed. Reg. 47022 (Dec. 11, 1987).] The CFTC never explains why the existence of unique protections offered by exchange trading require regulation of only exchange trading.

The Commission's position is made all the more self-contradictory when contrasted with the agency's observations about the OTC markets. For example, in 1993 the CFTC expressed concerns about the "price opacity" of dealer markets and its impact "on the effectiveness of risk management" since "reliable price information is integral to effective risk management." [OTC Derivative Markets and Their Regulation at 116.] Indeed, the CFTC found that "lack of price transparency in OTC derivative transactions also has been cited as a potentially exacerbating factor in periods of market turbulence." [Id.] Despite these acknowledged risks, the CFTC is comfortable allowing only OTC dealers to offer virtually unregulated "professionals only" markets in futures and options.

Objective market observers also have found that OTC markets provide price discovery and price basing similar to exchange markets. According to a 1993 Congressional Research Service study, many OTC derivatives now trade in a "large and liquid marketplace" where "traders could adjust their positions very quickly." [CRS Report for Congress: Derivative Financial Markets, 30 (October 29, 1993).] Through this OTC market liquidity, CRS found that the price discovery and hedging benefits exchange markets traditionally have offered "are now available to users of the [OTC] derivative markets." [CRS Report at 17.] Price basing also exists in OTC dealer markets. The Economist has reported that one "indicator of firms' view of interest rates is the spread between interest rate swaps and government bonds over which they are priced." [The Economist, "How low can they go?" 94 (Oct. 30, 1993).] Thus, price discovery and price basing offer no reasoned basis for the CFTC's efforts to discriminate against exchanges.

The CFTC's Earlier Reports All Support ProMarket

Trading on an exchange is different than trading through an OTC dealer. But those differences make exchange trading safer, not riskier. Usually Congress wants to regulate the riskier, not safer, activity. The CFTC has offered no reason why the safer exchanges need to be subject to an intense and costly array of federal regulation, particularly if trading is limited to professionals only, while similar professional OTC markets need no regulation. The CFTC's prior statements and reports underscoring the benefits of exchange markets actually offer strong support for the ProMarket relief S. 257 contemplates. The CFTC's more recent efforts to convince Congress to regulate what the agency acknowledges to be a safer form of trading should not be given great weight.

ProMarkets Will Benefit From Exchange Self-Regulation

Some observers have expressed concern that ProMarket trading, relying primarily on

exchange self-regulation, will lead to unregulated trading anarchy. Nothing could be further from the truth. Any exchange sponsoring a ProMarket would have every business incentive to operate a fair, financially sound and competitive trading market. For those very business reasons, no exchange would want its self-regulatory capabilities questioned. Congress therefore has a right to expect exchanges to be most vigilant in policing these markets.

The experience and record of futures clearing systems is strong evidence supporting this claim. Over the years, the CEA and CFTC activity have seldom aimed at the exchanges' clearing systems. By far, most of the provisions of the CEA have focused on sales and trading practices (with an eye toward protecting the retail public customer), rather than on the clearing system. In short, the statute and agency, by and large, have left the clearing process to self-regulation.

During that time, exchange clearing systems have amassed a remarkable record. Defaults by exchange clearing members have never occurred under most clearing operations and on others are rare, to say the least. (In short, any bank regulator would love to have the financial integrity record of exchange clearing systems.) All that success was accomplished under what is primarily a self-regulating system where the self-interest of each clearing member counsels prudence at all costs. Thus, aggressive federal regulation is not the only way to provide effective safeguards.

Some have claimed that ProMarket clearing will create problems caused by potential "spillover" with the existing clearing systems. But the exchanges are understandably proud of the success and safety of their clearing systems. Exchanges operating ProMarkets would not want to tarnish in any way that perfect record. Taking undue risks in ProMarkets that would jeopardize existing clearing systems would be both bad policy and bad business. Those fears should be put to rest.

Moreover, in today's derivatives markets, the activities of OTC dealers may create systemic risks that could jeopardize traditional clearing systems, a risk confirmed by the Bachmann Report to the Securities and Exchange Commission in 1992. The ProMarket exemption would reduce that risk and strengthen U.S. markets by allowing exchanges to attract more OTC derivatives business to safer exchange trading and clearing systems. Those clearing systems could include cross-margining between traditional and ProMarket transactions, thereby further reducing systemic and credit risk in the system.

It is true that ProMarket transactions would rely upon market discipline and private market self-policing rather than government mandates. The ever growing OTC swaps market confirms, however, that government regulation is not needed to support a thriving professional market. S. 257's faith in self-regulation is not unique. As Thomas A. Russo has explained, "self -regulation is not new. It is a cornerstone of the financial markets, with the securities and futures exchanges performing under this system admirably over many decades." [T. Russo, Let Wall St. Handle Derivatives Rules, N. Y. Times 13 (May 15, 1994).]

Federal Reserve Board Chairman Alan Greenspan put it more directly. Chairman Greenspan told Congress: "There is nothing involved in Federal regulation per se which makes it superior to market regulation." [Transcript of Oversight Hearing on Derivative Financial Markets Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, 103d Cong., 2d Sess. 59 (May 25, 1994).] S. 257's ProMarket provision would enact Chairman Greenspan's salutary principle into federal law and should be adopted.

CONTRACT DESIGNATION (Section 7)

Legislative Change Is Needed to Cut the Red Tape

U.S. futures exchanges have over 100 years of experience as self-regulatory organizations. They have state-of-the-art systems to maintain orderly and efficient markets and to assure financial integrity, as well as excellent capabilities to develop innovative and successful products.

Nonetheless, largely because U.S. exchanges' authority to implement their innovations is limited under current law and CFTC regulations, an exchange's ability to adjust to changes in the marketplace and to compete against less-regulated foreign markets or unregulated OTC markets is severely hampered.

One area in which this lack of authority is particularly detrimental is in the development of new contracts. Each time an exchange develops a new contract, it must submit an application for designation to the CFTC with extensive and detailed analyses, specifications and statistics, and an open-ended obligation to furnish additional information at the CFTC's request. The costs of preparing the volumes of information required by the CFTC is enormous. Review of an application by the CFTC can take months, during which time a competitor can copy the idea and move forward. In addition to the designation process, an exchange's rules establishing terms and conditions for a futures contract must be pre-approved by the CFTC.

Designation and rule approval requirements result in substantial costs to the CFTC and unnecessary additional costs for exchanges. They also result in lost opportunity and place the U.S. futures exchanges in jeopardy of losing their competitive edge. Exchanges may have plans for innovative contracts, but they are hesitant to move forward because of the current regulatory scheme. These contracts would immediately attract formidable competition from other exchanges or OTC markets given the advance notice they would receive due to the lengthy CFTC review process.

Four legislative changes are needed to enable an exchange to introduce a new contract more quickly, so the U.S. futures industry can remain competitive.

First, once an exchange has met the significant requirements to be designated as a contract market, it would not have to repeat this process for each new contract it introduces. Second, the requirement that the CFTC affirmatively approve new contracts

would be repealed, although the CFTC would retain authority to initiate disapproval proceedings if it believes the rules for a new contract would violate the Commodity Exchange Act or CFTC rules. Third, exchanges and the Commission would both be freed from the costly requirement that they prove a negative, namely that proposed contracts are not contrary to the public interest, although the CFTC could disapprove a new contract rule on terms and conditions because it violates the public interest. S. 257 addresses these three issues. However, another change is also needed. The CFTC should be required to complete any disapproval action within a reasonable period of time, which we believe would be 60 or fewer days.

To be designated as a contract market, an exchange must show that it has the self-regulatory structure and capabilities to comply with CEA and CFTC requirements for recordkeeping, membership, governance, prevention of price manipulation, trade monitoring, market surveillance, compliance with market rules and so on. Once designated, an exchange must maintain these systems and is subject to regular reviews by the CFTC. Thus, requiring a repetition of the designation process each time an exchange develops a new contract is completely unnecessary. Under section 7, an exchange would go through the time consuming and costly designation process only once, rather than each time it introduces a new contract.

Also under section 7, the CFTC would no longer be required to approve the terms and conditions of a new contract before trading can commence. This will save substantial CFTC staff time and resources which are now spent on reviewing, and often second-guessing, the work of the exchange.

Exchanges have an economic motive to develop contracts that work -- it can cost a million dollars or more to develop a contract and to initiate trading. Exchanges hold lengthy consultations with the affected commercial interests in order to develop terms and conditions that meet the needs of potential hedgers. CFTC staff review does not add much value to this process, although it does increase the cost to the U.S. Government as well as to the exchange.

In its December 26, 1996 letter to Committee Chairman Lugar ("CFTC Letter"), the CFTC asserted that section 7 is "potentially harmful to the public interest and would preclude meaningful Commission review of contracts." [CFTC Letter at p. 5 of Attachment A.] We do not agree. Prior to the initiation of trading, an exchange would still have to submit the rules setting forth the terms and conditions of, and otherwise governing trading in, the product to the CFTC. The CFTC would continue to have the opportunity to initiate disapproval proceedings if it believes those market rules violate the CEA or Commission rules, or are contrary to the public interest.

Even though section 7 would make several important improvements, it does not go far enough. The lack of a firm deadline for action by the CFTC is one of the main problems with current procedures. The CFTC reports that, on average, it takes 90 days to review a new contract. This legislation would allow an exchange to commence trading in a new contract if the CFTC does not complete disapproval proceedings in 120 days, but the

CFTC could disapprove the contract any time after this 120th day and the exchange would have to cease trading. We recommend that this provision be modified so that no more than 60 days after the submission of contract rules, disapproval proceedings must be completed or the contract can be made effective and trading may commence.

CFTC Concerns About Streamlining the Process are Overstated

It is the CFTC's view that the Commission's review of prospective contracts can ensure that they are not readily susceptible to manipulation. [CFTC Letter at p. 5 of Attachment A.] Yet, before trading commences, the CFTC cannot judge any better than the exchange whether a contract would be subject to manipulation. Needless to say, properly designed contract terms are very important and an exchange will take all the steps it can to develop a contract that is not subject to manipulation. Our reputations and the interest of our members are at stake. We have the staff expertise and, when necessary, do not hesitate to call on outside experts to assist in designing the best contracts possible.

The CFTC Letter cites the London Communiqu, on Supervision of Commodity Futures Markets, issued on November 26, 1996 by representatives of regulatory authorities from 17 countries, as supporting its contention that pre-screening of contract terms is the best way to protect against manipulation. [CFTC Letter at p. 5 of Attachment A.] However, the Communiqu, does not support the premise that it is necessary for a government regulator to review a contract's terms and conditions before trading can commence. The participating regulators endorsed the following statement:

> The consideration of appropriate contract design principles by relevant market authorities to ensure that the terms and conditions of commodity contracts, including cash settlement terms, if applicable, minimize the susceptibility of such contracts to abusive conduct. [Communiqu, at p. 3.]

The term "market authorities" is defined to include "markets and/or self-regulatory organizations" as well as regulatory entities. Thus, the Communiqu, does not suggest that prior review by a government regulator is necessary or any more valuable than the work of an exchange to develop a well designed contract.

Even the Commission recognized that the one-year period provided for new contract approval in current law is excessive. In November, it proposed regulations to streamline the approval of some new contract applications. [Federal Register, November 22, 1996 at page 59386.] While the Commission's proposal is a step in the right direction, we firmly believe that a legislative solution is necessary to comprehensively address the issue of the Commission's review and possible disapproval of new contract and other exchange rules.

Among other things, the bill will retain the Commission's authority to prohibit the implementation of a new contract if the Commission determines that it is contrary to the public interest. Thus, the legislation will free both exchanges and the Commission from proving the negative that every new contract is "not contrary to the public interest". Instead, the Commission and the exchanges will be allowed to focus their analytical

resources on those rare contracts that the Commission has reason to believe will be contrary to the public interest.

The CFTC Letter also contends that because of the CFTC's November 1996 proposal on designations and new contract rules, amendments to the Act are not necessary. [CFTC Letter at pp. 4-5 of Attachment A.] Essentially, the CFTC November proposal would deem certain applications for contract market designation as approved in 10 days, and others would be deemed to be approved in 45 days. However, for many reasons, these proposed rules only provide cosmetic changes and would not have much of an impact on the problem of bureaucratic delay. For example:

Only a limited number of contracts would meet the CFTC proposed standards for abbreviated review. Any "novel or complex" contracts, stock-index contracts, agricultural products or those that provide for delivery would continue to be subject to a lengthy review process. This would undercut any effort to trade a new product before the competition gets wind of the idea.

By not allowing abbreviated procedures for contracts with physical delivery, the CFTC is implying that physical delivery contracts are somehow more complicated than cash-settled contracts, which is not the case.

There are no changes in the submission requirements or the amount of scrutiny that the CFTC will apply to each new contract. While the rules purport to set short time limits for action after applications for designation are filed, they do nothing about reducing the enormous paperwork and other time consuming actions that must be taken before an application can be filed.

These rules provide no real time limits; CFTC review could continue indefinitely. The abbreviated review process automatically reverts to the regular process if an exchange decides to make any changes in its submission. The CFTC can extend the review period for an additional 30 days if it decides the designation application raises "novel or complex" issues. The CFTC can ask for a new submission if it finds the rules to be "materially incomplete", which is a catch-all phrase that can be used if the CFTC disagrees with some part of the rule. Finally, the CFTC can terminate the fast track review procedures and revert to the old timetable if it appears that the proposed contract may violate a specific provision of the Act, CFTC regulations or form or content requirements.

A public comment period would still be required for certain contracts, even though the input from this process does not provide appreciable substantive information. Moreover, this is inconsistent with CFTC practices for reviewing contracts or proposals from less regulated or unregulated entities. For example, with very little information about the product and no request for public comment, the CFTC will process a request that the CFTC take no action regarding an off-exchange product. Similarly, public comment is not sought by the CFTC on the terms and conditions of foreign futures and options that are offered in the United States.

DELIVERY BY FEDERALLY LICENSED WAREHOUSES (Section 8)

As proposed in Section 8 of S. 257, repeal of obsolete Section 5a(a)(7) of the Act will eliminate the conflict which now exists between an exchange's self-regulatory responsibilities imposed under the CEA and federally licensed warehouses' ability to deliver against a U.S. futures contract.

Under the Act, exchanges must adequately monitor the availability of deliverable supplies for indications of possible congestion or other market situations which are conducive to possible price distortions. A primary tool for accomplishing this is an exchange-administered system of "registered" warehouses whose regular reports on deliverable supply information are aggregated and publicly disseminated. Section 5a(a)(7), modeled on a 1934 provision of the U.S. Warehouse Act, provides any federal warehouse that meets broad minimal standards with the opportunity to deliver on a futures contract without meeting exchange reporting requirements. As a result, the exchange may not know the level of truly available deliverable supply since supplies from unregistered warehouses may be delivered on a contract. The potential for disrupting the delivery process and tipping the balance between the makers and takers of delivery of a physical commodity are very real. As recently as 1994, an "unregistered" but federally licensed warehouse invoked this provision.

S. 257 takes the wise step of repealing this inconsistent provision and is supported by all U.S. futures exchanges.

SUBMISSION OF RULES TO COMMISSION (Section 9)

Eliminating Pre-Approval of Exchange Rules is an Important Step Forward

Similar to the situation with rules on contract terms and conditions (see comments on section 7), many other exchange rules must also be reviewed, and some must be pre-approved, by the CFTC. This time-consuming and costly rule review and approval process is not necessary. A fundamental role of an exchange as a self-regulatory organization is to have in place a well-defined process to develop rules and to oversee the markets. The only time that the CFTC should hold up implementation of an exchange rule is if it believes it violates the Commodity Exchange Act or CFTC rules and therefore, the CFTC initiates disapproval proceedings.

The proposed changes in section 9 make sense economically, since the CFTC staff will not have to repeat the work conducted by exchange staff, and as a policy matter, since development of rules in compliance with the Act is a duty of exchanges as self-regulatory organizations. Exchange rules undergo extensive preparation and scrutiny before they are submitted to the CFTC. It therefore makes little sense to have the CFTC repeat the process after submission.

The CFTC Letter (at p. 7 of Attachment A) states that the 10-day time limit that would be

imposed by this section is too short. Although the CFTC processes a "high percent" of exchange rules within 10 days, they believe that some rules require more time. Some of the rules they point to relate to terms and conditions of contracts, which were discussed in our comments on section 7. Others are rules that relate to financial integrity of the market, novel trading procedures, linkages between exchanges and the application of new technology to the marketplace. However, some of these rules are the very ones that need quick implementation because they are developed in response to competitive pressures. Innovations such as linkages with foreign exchanges allow U.S. exchanges to expand their markets. As another example, special processes for large lot transactions can attract business that now goes to the OTC markets because of fear that a position would become known if transacted on an exchange.

Just because an exchange is permitted to go forward with a new rule does not prevent the Commission from forcing changes if necessary or appropriate pursuant to section 8a(7) of the Act. The approach of section 9, which we strongly support, is to cut the red tape, allowing exchanges to focus their resources on improving their markets and developing new products. Among other things, this will put the U.S. exchanges in a far better position to compete with OTC markets and foreign exchanges.

Time Limits for CFTC Action Are Also Needed

Although section 9 makes some important changes, we believe two additional changes are needed to reduce the amount of time it takes for the CFTC to act on exchange rules. First, section 9 would wisely allow an exchange rule to be made effective if the CFTC does not complete disapproval proceedings within 120 days after submission. However, section 9 does not set a firm date for final CFTC action. It would continue to provide a loophole by stating that the CFTC could conclude the proceedings any time after 120 days and then disapprove the rule. Second, section 9 would require the CFTC to publish a notice of the rule in the Federal Register for public comment if the CFTC decides to institute disapproval proceedings, which not only is unnecessary, but delays action on the rule as well.

Without a firm time limit for CFTC disapproval proceedings, as discussed in detail in our comments on section 7, it could take months before a rule can be made effective. We believe that a maximum of 60 days is more than sufficient for CFTC action.

Further, requiring public comment on a rule when the CFTC decides to initiate disapproval proceedings is not appropriate. A disapproval proceeding is an administrative action and the CFTC's determination to disapprove a rule must be based on a finding that it violates a specific provision of the Act or CFTC rules.

The CFTC Letter also states that section 9 is not necessary because the December 1996 CFTC proposal to streamline the rule approval process would result in more than two-thirds of all exchange rules being processed within ten days, and would reduce the time for CFTC action on other rules. [CFTC Letter at p. 6 of Attachment A.] In general, the CFTC December proposal would allow certain rules to be deemed approved within 10

days, others in 45 days and still others, which would be published in the Federal Register for public comment, in 75 days. We do not believe these procedures will result in meaningful improvements or faster action for the following reasons:

Any rule that raises what the CFTC considers to be "novel or complex" issues would not be eligible for the 10-day review, and the CFTC could extend review up to 75 days. Since these are the rules that currently take the longest to process, there really will be no change in how they are handled by the CFTC.

The CFTC can remit any rule submission to an exchange for being "incomplete," thereby circumventing the 45- and 75-day deadlines. Indeed, the term "incomplete" is interpreted quite broadly. For instance, the CFTC could remit the rule on the 74th day if it decides that new questions have been raised about the "operation, purpose and effect" of the exchange's rule.

The CFTC proposal would expand the amount of information the exchange must collect and submit as part of its rule submissions -- thus adding red tape, rather than cutting it. One particularly onerous and unnecessary addition is the submission of information about the specific views of any party that may have opposed the rule, and identification of "the membership interest categories" of persons who were opposed. Explaining opposing views or concerns is one thing, but asking to identify the "membership category" is another. It implies that board members only act in their self interest and are not considering the overall interests of the exchange and its members.

Under section 5a(12), the CFTC must review rules of "major economic significance", place a notice the Federal Register and allow for public comment. The CFTC's December proposal would continue this practice. The only way to change this is to amend the Act.

AUDIT TRAIL (Section 10)

Last year, the Exchanges asked Congress to make certain that exchange efforts to detect and deter violations on our trading floors would not be compromised by a quixotic search for a specific technology, heretofore unattainable, that the Commission might decide should be implemented to enhance existing exchange audit trails. Since that time, the Exchanges have each made great strides toward perfecting our audit trail and related surveillance systems. In that effort, each exchange has been working cooperatively with the Commission and its staff to achieve our mutual goals.

Today, the audit trail systems employed by U.S. futures exchanges are the best in the world. No other auction markets even come close to the surveillance capabilities of the exchanges. That achievement should be a source of pride for this Committee, the Commission and the exchanges and should be reflected in new statutory provisions confirming that existing audit trail systems are effective, efficient and more than adequate to satisfy the requirements of current law.

Despite the gold medal performance of exchange audit trail systems, legal uncertainty

still exists in the application of the audit trail provisions enacted in 1992. Some exchanges have been told by the Commission that they qualify for a good faith exemption from the statutory audit trail standards since those exchanges have achieved "substantial compliance." Other exchange systems are still undergoing testing to see whether their audit trail performance merits a similar good faith exemption. No exchange has been told that its systems meet the elusive, ever changing (at least according to the Commission) statutory standard enacted in 1992. Instead, the Commission keeps raising the bar higher and higher, leaving the exchanges unsure what eventual height they must clear.

This legal uncertainty comes at a tremendous price. The Exchanges have expended substantial efforts to satisfy the statutory audit trail requirements. Tens of millions of dollars have been spent and many thousands of hours devoted to trying to measure up to what they perceived to be the standards enacted in 1992.

The current state of legal uncertainty is counter-productive. The Commission's efforts to raise the bar further to meet uncertain standards have reached an area of diminishing returns where prohibitively expensive changes to the way we do business would reap only nominal benefits in terms of audit trail accuracy.

To remove the current legal uncertainty, the Committee should consider adding audit trail provisions confirming that current exchange audit trail methodologies, if properly implemented, would satisfy the statutory standards. H.R. 467 offers one approach to achieving that objective by confirming the validity of certain means for recording trade timing data, trading card pick ups and time stamps for customer orders.

Congress should also impose a cost-benefit analysis on future changes to our audit trail systems. That measure would not prevent progress toward perfecting current audit trails. We believe that future enhancements to our systems should be implemented only if their perceived benefits to our markets outweigh the perceived costs.

One way of accomplishing this result is to condition the 1992 audit trail provision with the phrase "to the extent practicable" which contemplates a cost-benefit requirement. Another way is to run all Commission recommended audit trail enhancements through the cost-benefit filter contemplated by Section 11 of S. 257. Yet another avenue could be the approach taken in H.R. 467, which would streamline the 1992 statutory audit trail requirements to achievable and objective performance standards. The approach taken in H.R. 467 is the most clear cut and practical solution.

S. 257 does take important steps in the right direction by reconfirming the Commission's interpretation of the 1992 audit trail standard. First, the bill would confirm that the means for achieving audit trail compliance must be selected by the contract market, not imposed by the Commission. Second, the bill would codify the Commission's stated view that the 1992 statute did not mandate that exchanges use electronic hand-held devices or any other new technology to meet the 1992 audit trail requirements. In that regard, to avoid any confusion, we would suggest that the word "specific" be deleted from the new CEA 5a(b) language. Otherwise the provision might be misconstrued to allow the CFTC to

dictate a type of technology -- like a hand-held device -- but not a specific brand or kind of device.

CONSIDERATION OF EFFICIENCY, COMPETITION, RISK MANAGEMENT AND ANTITRUST LAWS (Section 11)

As we testified last June, our business, risk management, has completed its transformation into a global enterprise. Futures and options markets foster their business of providing risk management services by offering low costs and liquid markets. U.S. futures markets are world leaders because our costs have been lower and liquidity better than those of our foreign rivals.

Our foreign competitors are rapidly cutting into our lead by copying our best features and avoiding the regulatory and structural defects that weaken our markets. Regulatory excesses jeopardize our fragile competitive lead and threaten the export of this cost-sensitive business to jurisdictions that understand that rational reductions of regulatory costs will attract this highly-mobile business. This says nothing of the competitive threat to our industry from over-the-counter markets in this country and elsewhere that operate with no comparable regulation.

We support the enactment of an enforceable requirement that the Commission consider the real world costs of its actions on the industry before it acts, measured against the real world benefits of its actions, if any. Although the Exchanges prefer the more quantifiable cost benefit analysis that would be required by Section 106 of H.R. 467, Section 11 of S. 257 represents a solid first step toward the enactment of this goal.

It is noteworthy that in the CFTC's December 26 letter to Chairman Lugar, Chairperson Born argued that section 11 is unnecessary "because the Commission already considers these factors in taking regulatory action". If indeed the Commission has been considering these factors, it is not readily apparent to the exchange community. The Commission also asked that Section 11 be changed to apply to only regulations with more than $100 million impact on the futures industry. That limitation would effectively eliminate the cost-benefit requirement. We know of no CFTC rule that would satisfy the $100 million standard. Moreover, the Commission asked to be the sole arbiter of its own cost-benefit determination by precluding judicial review of that determination. Without judicial review, a cost-benefit requirement would have no teeth. We are pleased that you have not watered down the common sense cost-benefit analysis requirement in your re-introduced bill.

DISCIPLINARY AND ENFORCEMENT ACTIVITIES (Section 12)

In an era when government must do more with less, duplication and inefficiency should not be tolerated. In recent years, from time to time, the enforcement activities of the self-regulatory organizations (both exchanges and the National Futures Association) and the enforcement efforts of the Commission have either overlapped or conflicted. Better management of enforcement resources would serve the public interest as well as the

interests of the Commission, the SROs and market participants.

For that reason, the Exchanges last year asked Congress to identify enforcement resource allocation priorities for the Commission and the SROs. A sensible division of responsibility seemed to call for the SROs generally to enforce their rules against their members and for the Commission to enforce its regulatory regime against non-SRO members. The Exchanges also suggested that better coordination between the Commission and its SROs could lead to better enforcement.

Section 12 of S. 257 attempts to address the duplication issue through a "sense of Congress" resolution calling upon the Commission to avoid "unnecessary duplication" of enforcement efforts. While we do not know when duplication would ever be "necessary," the exchanges do not oppose the substance of this "sense of Congress" provision, but we do not believe that much is gained by this non-binding recommendation. We note that the Commission's December 26, 1996, letter to Chairman Lugar states that the "sense of Congress provision" "confirms the existing practice of the Commission and its enforcement staff." If that is true, then the exchanges respectfully suggest that the "sense of Congress" provision is not needed.

In addition, it does not seem necessary to amend the Act to require the CFTC to report on its enforcement activities, since this purpose could be accomplished by a letter from the Committee to the CFTC.

DELEGATION OF FUNCTIONS BY COMMISSION (Section 13)

The Exchanges also question whether Section 13 is needed since it does not direct the Commission to take any particular action. The Commission's December 26 letter to Chairman Lugar states that the agency has "traditionally explored areas where it can call on SRO resources to assure the effectiveness of its programs at reduced taxpayer costs." If the Commission informs this Committee that it will conduct a review in this area, with the goal of identifying where further delegation of authority to SROs is possible, then we see no compelling reason for adding to the statute the "sense of Congress" provision as written and its accompanying report. The exchanges agree with the Commission that NFA has "done an admirable job in carrying out its assigned tasks" and would urge the Commission to make better use of NFA's many capabilities in the future.

CONCLUSION

The authors of S. 257 have taken a bold and welcome step in recognizing the needs of an important part of the U.S. business sector: the exchange-traded portion of the global risk management industry. The U.S. futures exchanges have been forced to compete while shackled by an outmoded regulatory structure which imposes opportunity-consuming time delays and unnecessary and/or duplicative expenses on a highly cost-sensitive business. The more inventive the product, the greater the competitive threat, or the higher the profile of the issue, the more the inefficiencies in the existing process have hurt the U.S. futures exchanges.

S. 257 begins to address these potentially fatal inequities. It recognizes and reiterates a fundamental tenet of the U.S. regulatory system: self-regulation by the industry combined with pragmatic oversight by the CFTC provides effective regulation. It strikes a tolerable balance between market-driven incentives and federally mandated goals for regulation. As noted above, Federal Reserve Chairman Alan Greenspan has offered strong support for this tenet, saying: "There is nothing involved in Federal regulation per se which makes it superior to market regulation."

We look forward to working with the Members of the Senate Agriculture, Nutrition and Forestry Committee on this legislation as the process continues in the weeks ahead.