Prepared Testimony of

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Hearing on the Derivatives Markets Transparency and Accountability Act of 2009 Before the U.S. House Committee on Agriculture

February 3, 2009

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

Introduction

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

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

Draft Bill

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

- preventing price manipulation,
- avoiding systemic risk and counterparty defaults through clearing,
- protecting customers and

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

- encouraging competition and innovation.

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

But many of the draft Bill's provisions would <u>disserve</u> the very public interests and economic policies Congress designed the CEA to serve by draining market liquidity, making hedging more costly, curbing innovation and discouraging trading in the U.S. We cannot support those sections of the Bill. Attached to this testimony FIA has included a section-by-section review of the draft Bill which describes our positions on its specific sections.

FIA's Principal Objections

To summarize our objections, FIA fears the bill would:

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

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

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

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

Our major concerns center on provisions in Sections 6, 13 and 16 of the Bill.

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

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

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

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

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

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

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

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

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

In addition, mandatory clearing of credit and other derivatives could lead to uncertainty in credit and other markets at a time when we are struggling to stabilize or restart

those vital economic functions. It is true Section 13 authorizes the CFTC to exempt classes of OTC derivatives from the clearing mandate. As drafted, however, Section 13 would severely constrict the CFTC's ability to exempt OTC transactions.

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

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

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

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

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

CFTC Regulation

FIA understands that Congress soon may receive proposals on financial market regulatory restructuring. In that regard, one aspect of the recent financial market turmoil must be highlighted. Despite unprecedented financial turbulence that has led to bankruptcies and

bailouts, the U.S. futures markets have performed flawlessly. Fair and reliable prices have been discovered transparently. Hedgers have managed price risks in liquid markets. All trades have been cleared. Customers have been paid. Not a blip.

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

One feature of the current regulatory system that must be preserved is the exclusive jurisdiction of the CFTC over all facets of futures trading and related activities. Congress long ago determined that other federal or state regulation should not duplicate or conflict with the CFTC's regulation of the futures markets. We know this Committee has been vigilant in protecting this important public policy which has allowed CFTC-regulated futures markets to prosper for many years.

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

Conclusion

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