Prepared Testimony of

John M. Damgard

President, Futures Industry Association

Hearing on Credit Derivatives, Before the U.S. House Committee on Agriculture

December 8, 2008

Mr. Chairman and members of the Committee, I am John Damgard, President of the Futures Industry Association. FIA is pleased to be asked to discuss some of the issues raised by plans to clear credit default swaps. We know this Committee has been actively involved in these issues for many months. FIA greatly appreciates the leadership you have shown, Mr. Chairman, along with Ranking Member Goodlatte and the other members of this Committee.

Just to establish some common vocabulary, credit default swaps are derivatives designed to manage the risk that a credit event will occur in the future. Those credit events are defined by contract and range from a corporation's failure to make an interest payment to its corporate restructuring. Credit default swaps may involve indexes of credit events for many companies or credit events for a single corporation. That is why you hear discussion of indexed CDS instruments and single name CDS instruments.

FIA is not here today to debate the value of credit default swaps or to champion one clearing proposal over another. We believe credit default swaps add value to our economy. We also believe that an appropriately-structured and regulated CDS clearing system would enhance that value. As this Committee appreciates, clearing would remove counterparty performance risk, reduce systemic risk and increase price transparency for eligible CDS transactions.

FIA has three basic points. First, the vital interests of clearing firms must be recognized in the proper structure of any successful CDS clearing operation. Second, government agencies should not make CDS clearing a jurisdictional football. Third, merging the CFTC and the SEC will not answer the financial market regulatory concerns Congress has raised in recent months.

As this Committee is aware, FIA's regular members are the clearing firms. Many may overlook the role these firms play in any clearing system. But the simple truth is the clearing firms are the lifeblood of clearing. The clearing firm is financially responsible to the clearing house for every trade it clears. Each clearing firm puts its capital at risk at the clearing organization to guarantee performance on the firm's trades and its customers' trades. In effect, the clearing firm is financially underwriting its customers' performance. Each clearing firm knows that its capital is standing behind the other clearing firms in the system and may be called upon if another clearing firm fails. That is why clearing systems are known as mutualized-risk systems.

In any clearing system for CDS instruments, FIA would expect the clearing firms to play a similar role. No clearing firm should be asked to commit its capital to a clearing system unless the firm is comfortable that its capital will be well-protected. The U.S. futures industry is proud of its unparalleled record in this regard. We are sure this Committee will want to make certain that any of the CDS clearing systems now being considered will meet that high standard of excellence, including the capital standards for any new clearing members.

One structural issue that has been raised concerns whether to commingle the risk pool that already exists for futures clearing with the CDS risk pool. An alternative clearing approach would treat the CDS clearing pool as a separate, self-contained structure. FIA does not have a view now on which approach would be preferable from the perspective of the clearing firms. We do believe the Committee and the relevant agencies should pay particular attention to

developments in this area to make certain that the strongest possible CDS clearing solution will be allowed to develop.

Another structural issue is often referred to as interoperability. As CDS clearing evolves, it is unclear whether one clearing system will predominate or whether multiple systems will thrive. In the event more than one system is successfully launched, the regulators should consider a plan to allow an appropriate linkage for the clearing systems that would meet the related challenges of protecting against systemic risk through the most efficient use of a clearing firm's capital.

We suspect the Committee has heard about the interoperability issue, and others, in its recent fact-finding trip overseas and that you will monitor carefully any developments in the U.S. on this issue. Your trip underscores that we can not develop CDS clearing policy in a vacuum. The CDS market is international in scope and our policies must work both domestically and internationally. The CDS clearing issue highlights that today national borders are becoming less meaningful for financial markets. We have one global financial market with global issues that require global cooperation and solutions.

These international issues also serve to remind us that domestic regulatory jurisdictional politics should not become a barrier to forging an appropriate CDS clearing policy. As the CDS market has evolved, it has become clear that it would serve the public interest to make a clearing system available for many of these credit derivatives. Given the current tightening of the credit markets, no agency's jurisdictional claims should be considered to be more important than the national economic interest. Current law provides a choice to those who want to try to clear OTC derivatives in the U.S. -- the clearing entity could choose to be regulated by the SEC, the CFTC or the Federal Reserve Board. Each regulatory body has had experience with the kind of prudential, safety and soundness regulatory judgments that clearing operations necessarily involve. And each regulator has pledged to follow the established guidelines, whether adopted by IOSCO or the Commodity Exchange Act, for the operation of an effective CDS clearing system.

Once a clearing system operator has chosen its regulator, that regulatory body should communicate and coordinate with its regulatory colleagues. The recent MOU adopted by President's Working Group rightly adopts this strategy. By emphasizing a process of inter-agency consultation, the MOU should lead to sharing information and regulatory suggestions among the PWG members with a view toward adopting a streamlined and unified set of oversight principles for CDS clearing in the U.S.

FIA understands the need for legal certainty and that the two U.S. clearing platforms have applied to the SEC for exemptions to provide that clarity. We would hope that those exemptions will not turn into an excuse to regulate CDS transactions or to prescribe additional requirements for clearing. If so, that would undermine the cooperative process the MOU structure has put in place. Congress has found the CFTC and the Fed to be qualified to oversee CDS clearing operations. They should be allowed to perform their statutory functions without interference from the SEC or other regulatory bodies.

In past hearings, the Committee has expressed concern about the basis for the SEC's apparent claim that once a CDS is cleared it becomes a security. In FIA's view, many CDS instruments are just as likely to be considered commodity options subject to CFTC jurisdiction under current law. Jurisdictional flag-planting seems short-sighted given the crisis facing our financial markets. The PWG's MOU process tries to keep that counter-productive activity to a minimum. We would urge the Committee to make certain that neither the SEC nor the CFTC attempts to use its exemption powers and the interest in legal certainty as an excuse to impose regulatory restrictions on CDS transactions that serve the agency's jurisdictional interests, but not the public interest.

Last, as I have testified for decades, no compelling case has been made to merge the CFTC and the SEC. Throughout the current credit crisis, the U.S. futures markets have continued to provide liquid, fair and financially secure trading venues for managing or assuming price risks. The CFTC's vigorous, expert and efficient oversight of our nation's futures markets has achieved an exemplary regulatory record that is cited throughout the world as the gold standard. That record illustrates the wisdom of this Committee's decision almost 45 years ago to give birth to the CFTC with exclusive jurisdiction over all facets of futures trading. That judgment is as sound today as it was then.

We understand that reforming financial market regulation is on the agenda of the new Administration and the new Congress. Many different suggestions have been offered for changing the regulatory status quo. FIA welcomes a healthy debate on how best to strengthen both our regulatory systems and our markets, nationally and internationally. All options should be on the table and explored fully. Through that process, we are confident Congress will agree that simply folding the CFTC into the SEC is not the answer.

We look forward to answering any questions this Committee may have.