Testimony of Greg Zerzan
Counsel and Head of Global Public Policy
International Swaps and Derivatives Association

Before the
U.S. House of Representatives
Committee on Agriculture
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Introduction

Thank you very much for inviting ISDA to testify today regarding over-the-counter (OTC) derivatives, the Commodity Exchange Act and recent activity in the commodity markets.

The Purpose and Role of OTC Derivatives in the Economy

As the members of this Committee know, OTC derivatives are used for a variety of risk management purposes. Initially developed in the 1980s, OTC derivatives have quickly become a core component of the risk management operations of financial institutions, manufacturers, producers, multinational corporations and investors both in the US and around the world. OTC derivatives are privately negotiated contracts, with the material terms of a transaction worked out between the parties. In this respect they differ significantly from exchange traded futures and options, which are standardized and fungible instruments subject to offset through the purchase of a contract with the opposite exposure.

In the energy commodity space OTC derivatives are used by a broad segment of market users looking to manage risks related to future price movements of energy. For instance, a large producer that is exposed to the price of oil through normal costs like fuel and the price of fertilizer can hedge its risks by entering into a swap agreement whereby it agrees to pay a fixed amount of money on a specified quantity, for instance $140 a barrel, over a specified period in exchange for receiving the floating price of crude over that same time. In this way the producer will guarantee that its economic exposure is no more than $140 a barrel and can budget its future operations on that basis. Likewise a utility company that relies on natural gas to power its generators can lock-in the future price of the commodity by entering into a swap agreement with a counterparty such as a bank or investment firm that is better equipped to deal with the risk of floating prices.

OTC derivatives were invented to allow companies to mitigate price shocks by passing on those risks to others that have the opposite exposure, or are better suited to manage them. These risks can be managed through custom-tailored contracts exactly suited to the company's risk management needs.

In some cases OTC derivatives are used to gain exposure to some underlying reference asset. For instance an institutional market participant such as a pension fund or university endowment might utilize an OTC derivative to benefit from the increase in the price of a basket of stocks or commodities. The reasons an institutional market participant might prefer to use an OTC derivative instead of futures or stocks can vary, but could include such factors as costs, the ease with which a swap agreement can provide diversification, legal constraints on its ability to invest directly in certain asset

classes, or the need to custom tailor a transaction for portfolio management purposes. Cost benefits are an especially important consideration; an investor can use a total return swap to access exposure to an underlying commodity without having to purchase and mange a bundle of futures contracts with different delivery dates. Equally important is that OTC derivatives are cash-settled, meaning an investor need not avoid physical delivery by purchasing offsetting futures contracts (and incurring those transaction costs as well).

OTC derivatives play a critical role in the global economy, and the markets are international in scope. However, despite the fact that OTC derivatives were first created in the United States, London has become the center of the global OTC derivatives business with roughly 43 percent of the world's daily turnover occurring there.

Derivatives are Not the Cause of Rising Commodity Prices

Recently there have been widespread accusations that derivatives markets, and in particular speculators in derivatives markets, are responsible for rising commodity prices.[1] Some accuse speculators of driving up the price of oil beyond levels justified by fundamental economic factors, as well as increasing volatility. Others point to the presence of investors in the market; it is asserted that even investors with a long-term perspective enter as buyers and put upward pressure on prices. And finally, because commodity derivatives, both exchange-traded and over-the-counter, reduce the cost of transacting in commodity markets, some call for restrictions on derivatives activity as a way to reduce pressure on prices. Unfortunately these arguments misunderstand the role of derivatives in informing commodity prices. Putting tighter restrictions and further regulation on derivatives will not reduce the price of oil, and might even make it more volatile.

Commodity derivative market participants can be divided into three categories. The first category is "commercial" participants, which include oil producers along with oil consumers such as airlines and refineries. Commercial participants often, but not always, use derivatives to hedge their exposures to prices and thereby reduce risks. The second category is non-commercial participants, which includes hedge funds, pension funds, and commodity trading advisers. Non-commercials are often identified as speculators, that is, participants that seek to take on risk in order to benefit from price increases or decreases. The third category is intermediaries, also known as dealers, which consist of banks and other financial firms as well as energy trading subsidiaries of energy producers and

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[1] It is worth noting that prices for a wide range of commodities for which there are no active exchange markets have likewise seen tremendous price appreciation. Since 2001 cadmium and molybdenum prices are up over 1000%; rice has appreciated over 500%; iron ore and steel have increased over 300%. Onions have increased over 300% this year alone as of April, 2008.

utilities. Intermediaries stand between hedgers and speculators in order to make a market.

All three types of participants act as both hedgers and speculators at different times, and all three types are necessary to an efficient and liquid market. For hedgers to be able to transfer unwanted risk there has to be someone to take on those risks. If dealers cannot find another hedger with the opposite, offsetting risk then dealers will look to speculators to take on those risks. In such a market, restricting and otherwise raising costs to speculators will ultimately raise costs to hedgers and make it more difficult to manage the volatility of the prices they seek to manage.

A recent criticism of derivatives has been that prices are higher than economic fundamentals would justify because both speculators and investors place excessive upward pressure on prices. According to this argument, investors use derivatives to enter as buyers in order to enhance their returns and to hedge against inflation, while speculators buy in anticipation of prices going even higher.

However, neither speculators, investors nor other derivative market participants are the cause of the level and volatility of oil prices. The reason is straightforward: physical possession of oil (or any other commodity) is necessary to drive up prices. Evidence appears to be lacking to support the necessary condition that speculators or investors have been taking physical possession of oil and withholding it from the global market.

The mechanics of the market can be explained as follows: assume that a combination of speculators, hedgers, and investors all take long futures positions. In isolation, all of these could potentially exert upward pressure on prices were it not for the presence of two other factors. First, for every long position there has to be a short position (a seller) on the other side. Second, all speculators, hedgers, and investors with long positions will be obligated to take physical delivery of oil when the contract matures unless they exit out of the contract beforehand. By selling contracts to exit their position (and virtually all of these market participants will do so) downward pressure will be placed on the price of oil. If the price were simply high because of all the pressure from buyers, then the downward pressure from the selling would cause the price to fall. But if the price of oil were to remain high anyway (as has been the case recently), it must necessarily be because there are participants with long positions who are willing to buy and take possession of oil. And this in turn could be either because someone has bought up oil supplies so other buyers drive up the price—which is market manipulation and therefore illegal—or because demand for the physical commodity has increased relative to the supply available, thereby leading to a higher price.

The above also applies with regard to over-the-counter markets such as swaps. OTC derivatives are bilateral agreements, the vast majority of which are cash-settled (and thus do not involve physical delivery). Additionally many OTC derivatives are hedged using

futures contracts, which as explained above means the contracts are eventually sold prior to maturity and thus exert downward pressure on prices.

Derivatives markets are price discovery markets; they reflect the willingness of buyers and sellers to agree to a price for any given commodity. While derivatives can help inform markets as to expectations of future prices they are naturally checked by the actual physical supply of the underlying commodity; in other words it is the market forces of supply and demand, not derivatives, which are the cause of rising commodity prices.

Recent Legal Developments and Legislative Proposals

(a) Recent Changes in US Law

Since passage of the Commodity Futures Modernization Act in 2000 there have been efforts to amend the provisions of that law relating to OTC energy transactions. Indeed, Congress has been very active in increasing federal oversight of the energy markets, such as the grants of anti-fraud authority to the Federal Energy Regulatory Commission over the natural gas and electricity markets (as part of the Energy Policy Act of 2005) and to the Federal Trade Commission with respect to the wholesale petroleum market (as part of the Energy Security and Independence Act of 2007). It is worth noting that the precise jurisdictional parameters of the FERC authority are still being decided; meanwhile the FTC has just begun its rulemaking process.

Meanwhile less than two months ago Congress, lead by this Committee, undertook the most sweeping changes to the Commodity Exchange Act since the passage of the CFMA. As you are aware the amendments to the law made by the CFTC Reauthorization Act of 2008, contained as a title of the Farm Bill, occurred after a year of hearings, countless conversations among policy leaders and market participants, consumer groups and producers and manufacturers, and the consideration and detailed recommendations of the President's Working Group on Financial Markets. The amendments to the law were made within the context of a thorough and carefully deliberated analysis of the current market, changes in the industry since passage of the CFMA, and a careful balancing of the costs and benefits of increasing oversight of the energy derivatives business. Ultimately, led by this Committee, the Congress passed legislation that won nearly unanimous praise from the industry, consumer groups and the regulatory community.

The provisions of the recently passed Farm Bill made important changes to how OTC markets are regulated, and are worth considering. For this discussion the most relevant provisions of the law are those relating to exempt commercial markets, which are markets among sophisticated commercial users that operate electronically. Under the new law those exempt OTC markets which list "significant price discovery contracts" are required to submit themselves to a new, principles-based regulatory regime that is modeled on those imposed on fully regulated markets. However, recognizing the unique nature of

these markets and the fact they are limited to professional participants, Congress chose to create a modified structure that retains important regulatory measures such as monitoring for abusive behavior, the ability to stop trading and the imposition of accountability limits while at the same time permitting the maximum amount of flexibility in order to encourage trading and accommodate innovation. Congress also created large trader reporting for significant price discover contracts as well as for agreements which are treated as fungible with such contracts by a clearinghouse. These provisions require substantive new reporting requirements for OTC derivatives.

Congress carefully balanced the desire for greater oversight of exempt commercial markets with a recognition of the global nature of these markets, the reality of international competition for the financial services business and an acknowledgement of the important role these markets play in allowing US companies to manage risk.

Over the last three years increased legal requirements have significantly expanded regulatory oversight and knowledge about the US energy market. While some may feel these changes were overdue, there can be no question that the rapid changes in the legal and regulatory requirements for engaging in energy transactions have been challenging for market participants. Because the exact scope and requirements of these changes in the law are still being implemented by regulators (and the precise compliance requirements still being discovered by market users) it is not clear what effect these changes will have on the markets. Nevertheless policymakers may be concerned about the business cost of imposing too many changes too quickly; the worst possible outcome would be one in which the ability of the market to produce services useful to consumers is impeded by regulatory and compliance issues.

(b) Current Legislative Proposals

A variety of approaches have been suggested for addressing rising commodity prices and the role of derivatives in commodity markets.[2] Some of these focus on the role of particular classes of market participants such as institutional investors and speculators; others would adjust margin requirements; some address the regulation of foreign boards of trade; still others would modify or repeal existing protections for OTC energy derivatives. ISDA's testimony will focus on this last category.

HR 6264 makes it unlawful to enter into a transaction in an energy commodity[3] in reliance on the 2(h) exemption or the 2(g) exclusion, unless the party entering into the

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[2] There are currently 23 proposed bills on this topic: Senate bills numbered 2991, 2995, 3044, 3122, 3129, 3130, 3131, 3185, 3202 and 3205 and House bills numbered 6130, 6238, 6264, 6279, 6284, 6330, 6334, 6341, 6346, 6349, 6372, 6377, and 6406.

[3] The proposed bills vary slightly in their definitions, but in general an energy commodity may include coal, crude oil, gasoline, diesel fuel, heating oil, propane, electricity, natural

transaction certifies that it has the capacity to take physical delivery of the energy commodity. HR 6330 requires that "included energy transactions," which are transactions in energy commodities for future delivery that provide for a delivery point of the energy commodity in the U.S., be conducted on a designated contract market (DCM) or derivative transaction execution facility (DTEF); "bi-lateral included energy transactions" are subject to recordkeeping and reporting requirements. The legislation would also curtail the CFTC's ability to use its exemptive authority with respect to included energy transactions. Separately, HR 6330 would expand the authority of the Federal Energy Regulatory Commission to issue cease-and-desist orders under the National Gas Act and the Federal Power Act; given the continued jurisdictional uncertainty regarding the division of CFTC and FERC authority one can envision a future in which market participants are uncertain as to which orders from which regulator they must seek to comply. HR 6341 would require all energy derivatives to be conducted on a registered futures exchange by removing energy transactions from the protections of the 2(h) exemption and the 2(g) exclusion. HR 6372 would remove energy commodities from the 2(g) exclusion and impose position and transaction requirements on energy swaps.

These proposals are not new. Since passage of the CFMA bills have regularly been introduced that would amend the protections for bi-lateral, privately negotiated swap agreements contained in the law. The above proposals were considered and rejected by Congress earlier this year when it adopted the new oversight provisions contained in the Farm Bill. Nothing that has happened in the last two months should fundamentally alter the carefully considered judgment of this Committee and Congress. Suffice it to say that the same rationale which led Congress to reject calls to restrict the ability of American companies to manage their very real risk of rising energy prices just two months ago hold even more true today. The protections of 2(g) and 2(h) allow parties to privately negotiate custom tailored risk management contracts. The above proposals, which seek to remove American companies' ability to do so, remain misdirected and potentially harmful.

Another area of interest to participants in the OTC derivatives markets are proposals to require separate disclosure or disaggregation of trading by index traders and "swap dealers". In considering such proposals it is important to remember that one of the benefits provided by regulated exchanges is the anonymity they provide to traders; futures markets reveal the prices market participants pay, not their motivations in making trades. Measures which seek to remove that anonymity could make traders seek markets which protect their ability to not reveal their motivations or individual market positions. Policymakers should carefully balance the legitimate desire of market participants to

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gas, any fuel derived from oil, any transportation fuel, uranium, and any other commodity as determined by the CFTC.

keep their market strategies and identities undisclosed. In any new reporting regime it should be ensured that no disclosure is required which would put any class of market participant at a disadvantage, including creating opportunities for other market participants to "front-run".

One additional area of particular concern are proposals such as those in H.R. 6330 to restrict or otherwise limit swap dealers and other intermediaries access to the futures markets to hedge their exposures to their counterparties. As already described, dealers and intermediaries provide valuable hedging, risk management and customized product offerings to their counterparties. A key part of these undertakings is the ability of these dealers and intermediaries to access the futures markets to lay off their exposures either on a case-by-case or on a portfolio basis. Without ready access to futures markets for hedging, these services would be more expensive and less efficient. At the same time, the futures markets would miss the important liquidity and pricing information these transactions provide. Forcing dealers and intermediaries to use non-U.S. markets or to create a network of bilateral hedging locations ill serves the dealers, their counterparties or the U.S. futures markets.

Competitive Considerations

As noted previously, the OTC derivatives markets are global in scope. Throughout the world governments have come to appreciate the value a dynamic financial services industry provides to local companies, as well as the significant benefits they provide to the national economy. National governments throughout Europe and Asia are actively competing to attract business and become financial centers. Recent regulatory overhauls in the UK, the European Community, Japan and South Korea all were guided in part by the desire to attract international financial services while at the same time bolstering local markets.

The US has long been a world leader in financial services. Currently the financial services industry provides 1 in every 20 jobs in the US while producing 8% of America's gross domestic product. The financial services sector is also a source of high tech innovation and a leading producer of "new economy," knowledge-based jobs. A leading example is the Atlanta-based Inter-Continental Exchange (ICE), which started in 2000 and now comprises one of the world's leading derivatives markets. ICE operates both OTC and regulated futures exchanges, and purchased the London-based International Petroleum Exchange to extend its presence into Europe. From its beginnings as a start-up company ICE is now a member of the S&P 500 and an employer of hundreds of Americans. Without the changes in US law created by the CFMA it is fair to say that ICE would not have achieved such tremendous success.

During discussion of the Farm Bill this Committee in particular was sensitive to issues of US competitiveness and the desire to ensure America's position as a world-leading

financial center was not harmed by inappropriate or unnecessary changes to US law. The competitive threats to the US have not disappeared since those deliberations. Although some nations have moved to restrict derivatives markets in response to rising commodity prices most of the US's immediate competitors have adopted a wait-and-see approach. In the European Union the European Commission has issued a white paper seeking to explore the causes of rising prices that has stopped well short of formal proposals to fundamentally alter the regulation of derivatives markets.[4] In the UK the Treasury Committee of the House of Commons also plans to investigate recent increases in commodity prices. It is worth noting that in the US the CFTC has began a comprehensive inquiry into rising commodity prices; whatever information the Commission receives will no doubt prove useful in considering public policy choices.

Given the global nature of the OTC derivatives markets and the financial services industry in general, there is no question that the imposition of overly restrictive regulatory requirements will lead to the reallocation of financial services business from the US to more friendly jurisdictions. As damaging as these prospects might be to the US economy an even greater danger lies in the possibility that assets will be priced in currencies other than US dollars.

For example, currently the world price of crude is set in US dollars, a currency which America obviously owns a monopoly in producing. There are many reasons the world prefers to price crude in dollars, including a favorable investment climate in the US; the historic strength of the dollar relative to other currencies; the widespread confidence the world has in the continued vitality of the US economy; and ultimately the faith market participants have that the US will honor its obligations. One particularly important reason to price crude (and other assets) in US dollars is the existence in the US of liquid, efficient markets for pricing assets. Without this mechanism for establishing prices there would be inefficiencies in the markets that would cause problems for producers, refiners, consumers and financial market participants alike.

Measures which would impair the ability of US markets to price assets and attract investors would likewise remove a significant incentive for the rest of the world to use dollars as the preferred pricing currency. Such measures would need not include an outright ban on derivatives (though it is worth noting that such a ban is not without historical precedent)[5]; measures which remove or limit certain market participants could

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[4] See for example European Commission, *Communication on Rising Food Prices*, (May 20, 2008). The Commission continues its deliberations under the Markets in Financial Instruments Directive regarding the application of that law to various types of commodity businesses.

[5] In 1958 Congress adopted an outright prohibition on the trading of onion futures in the United States, a ban which remains to this day. As noted above (ante fn. 1), onion prices have risen 300% as of April of this year. Fortune magazine recently ran an article

likewise remove liquidity and harm the efficient functioning of the markets, thus forcing more market participants out, creating a downward spiral. It goes without saying that the pricing of assets in currencies other than US dollars runs contrary to America's national interest.

Conclusion

Over the last year Congress and this Committee have carefully deliberated over the question as to what level of oversight is appropriate for OTC energy markets. After multiple hearings and considering the views of market participants, end users, consumer advocates and regulators, Congress less than two months ago passed broad changes to the law which carefully balanced the needs of these groups as well as concerns about the continued attractiveness of the US as a world financial center. These changes, which are still being implemented, should be given time to work. Furthermore, Congress should provide increased funding to the CFTC to ensure that the Commission has the resources necessary to execute upon its new authority and the numerous regulatory initiatives the Commission has recently announced.

As noted above, increasing regulation on over-the-counter derivatives will not lower the price of energy or other commodities. However, doing so will create incentives for relocating markets to outside of the US, remove tools for producers and commercial users to manage their risks, and harm the US economy. This Committee has historically been very sensitive to these dangers. ISDA thanks the Committee for your careful examination of these issues, and your continued leadership.

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quoting Bob Debruyn, a Michigan onion farmer whose father had worked hard to create the original onion-futures ban: "I would think that a futures market for onions would make some sense today, even though my father was very much involved in getting rid of it." *What Onions Teach Us About Oil Prices,* Jon Birger, Fortune June 2008.

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EMPLOYMENT

INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, Washington, D.C.
Counsel and Head of Global Public Policy: March 2006- Present

- Manage global policy for the over-the-counter derivatives industry, including working with regulators in the US, Europe and Asia to create pro-competition legal and regulatory regimes.
- Advise the Board of Directors regarding legal, regulatory and public policy matters. Review contracts and legal filings. Manage employees, outside counsel and consultants.
- Lecture about the OTC industry at international conferences, provide interviews to the media and testify at public hearings. Write editorials and articles educating the public about the industry.

UNITED STATES TREASURY, Washington, D.C.
Assistant Secretary (Acting): February 2005- July 2005
Deputy Assistant Secretary: March 2003- January 2005
Awarded Distinguished Service Medal, June 2005

- Managed Treasury departments in the areas of financial institutions, terrorism risk insurance and government sponsored enterprise oversight. Responsible for 7 offices and 100 employees.
- Responsible for creating and implementing government policy, including APA rulemaking and proposed legislation. Brief senior officials throughout the Executive branch including through participation in the President's Working Group on Financial Markets.
- Testified before Congress on Treasury policy. Wrote speeches and spoke at public events on behalf of the US government. Provided interviews for the media.

U.S. HOUSE OF REPRESENTATIVES, FINANCIAL SERVICES COMMITTEE, Washington, D.C.
Senior Counsel: August 2000-March 2003

- Advised Members of Congress on matters of law, procedure and policy. Drafted legislation and analysis of legal and regulatory matters.
- Served as lead counsel on the Sarbanes-Oxley Act. Worked with other staff to conduct congressional inquiry into the bankruptcy of the Enron Corporation.
- Appeared before Congressional committee to answer questions from Members and explain legislative initiatives.

DECHERT PRICE & RHOADS, Washington, D.C.
Associate: May- August 2000

Practiced in the Investment Management Group. Drafted corporate documents relating to securities offerings and structure, including private offerings and restricted sales.

U. S. HOUSE OF REPRESENTATIVES, AGRICULTURE COMMITTEE, Washington, D.C.
Counsel and Chief Counsel: September 1997-May 2000

Advised Members of Congress on agricultural law and policy. Lead counsel and drafter of Commodity Exchange Act reform for OTC derivatives. Wrote speeches and public policy statements.

KELL ALTERMAN & RUNSTEIN, LLP, Portland, Oregon
Associate: December 1996-September 1997

General Practice. Wrote contracts, negotiated settlements and represented clients in court, regulatory proceedings and before the Oregon State Legislature.

EDUCATION

WILLAMETTE UNIVERSITY COLLEGE OF LAW, Salem, Oregon: *Juris Doctorate*- May 1996
Dean's List

WILLAMETTE UNIVERSITY, Salem, Oregon: *Bachelor of Arts, Political Science*- May 1993
Dean's List

MEMBERSHIPS

Oregon State Bar 1996

District of Columbia Bar 1997

SELECTED PUBLICATIONS AND PRESENTATIONS

"On the growth and benefits of the international derivatives market," CEPS-Harvard Symposium on Building the Financial System for the 21st Century, Centre de Formation de Louveciennes, France, March 30, 2007.

"What does it mean for financial market stability when 40% of credit default swaps lack proper documentation?" *Policy & Markets Magazine,* February 2007.

"Global public policy overview," 2006 ISDA Regional Members Conference, Sydney, Australia October 23, 2006; Tokyo, Japan October 26, 2006.

"Recent regulatory, legislative and litigation developments," Practising Law Institute's Swaps and Other Derivatives Conference, New York, September 15, 2006.

"Developments in public policy related to the energy markets," ISDA Energy, Commodities & Developing Products Conference, Houston, Texas, June 14, 2006.

"Insuring against the risk of terrorism," Networks Financial Institute's Regulatory Reform Summit, Washington, DC, March 3, 2005.

"Testimony regarding the Federal Agricultural Mortgage Corporation," U.S. House of Representatives, Committee on Agriculture, Washington, DC, June 4, 2004.

"Sarbanes-Oxley and Shareholder Rights," National Investor Relations Institute Symposium on Corporate Governance and Shareholder Rights, Washington, DC, December 12, 2002.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2004.

Name: GREG ZERZAN

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Organization you represent (if any): ISDA

1. **Please list any federal grants or contracts (including subgrants and subcontracts) <u>you</u> have received since October 1, 2004, as well as the source and the amount of each grant or contract. House Rules do <u>NOT</u> require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:**

Source:__________ **Amount:**__________

Source:__________ **Amount:**__________

2. **If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) <u>the organization</u> has received since October 1, 2004, as well as the source and the amount of each grant or contract:**

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Source:__________ **Amount:**__________

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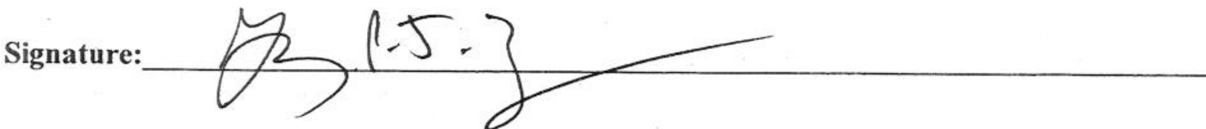

* Rule XI, clause 2(g)(4) of the U.S. House of Representatives provides: *Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof. In the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by any entity represented by the witness.*

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