CFA Consumer Federation of America

October 13, 2009

The Honorable Barney Frank
Chairman
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Spencer Bachus
Ranking Member
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Frank and Ranking Member Bachus:

We understand that the Committee plans a mark-up tomorrow of legislation to bring much needed regulation to the over-the-counter derivatives market. CFA believes that closing regulatory gaps – most importantly by regulating the OTC derivatives market – is the single most important step Congress can take to reduce excessive risks in our financial system. Unfortunately, the Committee's recently circulated discussion draft includes major loopholes that threaten to undermine that goal.

We are encouraged by recent statements that the Committee is open to revising the discussion draft. The twin goals of any such revisions should be: 1) to retain the strengths of the administration's original white paper proposal (mandatory exchange trading and central clearing for all standardized derivatives and safety and soundness and business conduct regulation of all derivatives dealers and major market participants); and 2) to close the loopholes that were included in the administration's draft legislation (in particular, exemptions from foreign exchange swaps and for contracts where one counterparty is not a member of a clearing facility).

Unfortunately, the discussion draft took the opposite approach. First, it greatly expanded the loopholes in the Treasury legislation, so that not only customized contracts but most standardized contracts could escape the central clearing requirement. Second, it eliminated the requirement for exchange trading. Some have concluded that – as a result of these broad exemptions from regulation for standardized contracts – the legislation actually offers weaker protections than current law.

The following are among the most important changes necessary to restore the protections promised in the administration white paper on regulatory reform:

- **Require that *all* standardized contracts be cleared through a fully regulated central clearinghouse.** Mandatory central clearing is the key reform that experts almost universally agree is essential to reduce the counterparty threats that nearly brought down the global financial system. In order to deliver the promised reduction in systemic threats, the administration's language, with its presumption that all standardized contracts must be cleared through regulated clearing facilities, must be restored. Furthermore, the discussion draft exemption for end users who use standardized derivatives to hedge risks and are not members of a clearing facility – an exemption that in effect could exempt all or virtually non-banks from the clearing requirement – must also be eliminated. There is no reason why end users cannot bring their contracts to a central clearing facility through a clearing firm, an approach that works well in other markets. Similarly, the exemption for foreign exchange swaps, the derivatives products that nearly brought down Long Term Capital Management, should also be eliminated, since failure to do so could swallow up the regulation that the legislation otherwise provides for currency and interest rate swaps.

- **Make exchange trading for standardized derivatives the rule rather than the exception.** Although the changes in the discussion draft were supposedly adopted to accommodate end users, it removes one requirement of the administration proposal that clearly benefits end users who use derivatives to hedge risks – the requirement that, where possible, standardized derivatives be traded on fully transparent exchanges or electronic trading platforms. Currently, dealers are able to exploit the opacity of the OTC market to charge excessive rents, and some end users do so to avoid regulation, hide risks, manipulate their balance sheet, or avoid taxes. The discussion draft perpetuates this opacity by eliminating the requirement for exchange trading. It also eliminates other benefits that come with exchange trading – a reduction in volatility, regulation of intermediaries, and exchange regulation to protect against fraud, manipulation, and other abusive practices. To promote transparency and enhance market protections, he exchange-trading requirement should be restored.

- **Eliminate the exemption from the definition of major market participant for end users who use standardized OTC derivatives to hedge risks.** The administration proposal permits the use of customized derivatives but provides for an appropriate degree of regulatory scrutiny by requiring all derivatives dealers and major market participants to register and subjecting them to capital requirements, record-keeping requirements, and business conduct rules. The discussion draft greatly undermines this provision by exempting those who use derivatives for "risk management" purposes from the definition of major market participants. We have no doubt that, if this language is retained, we will look back in a few years and see that it has allowed virtually the entire customized market – and because of the above-described related exemption from clearing requirements, the standardized market as well – to escape regulatory oversight.

- **Put reasonable limits on the use of customized derivatives for speculative purposes.** Instead of expanding the unregulated use of customized derivatives, the legislation should seek to ensure that these contracts are used only to hedge legitimate business risks. To accomplish this goal, it should require that, in any customized contract, at least one party to the contract certify and be prepared to demonstrate that it requires the customization to hedge a legitimate business risk. This would continue to permit some speculation, since one party to the contract could be a speculator, but it would help to eliminating contracts where both parties are speculating – contracts that add risk to the system without serving any economically productive function.

- **Narrow the exemption for foreign regulations.** Some have expressed concern that, if the U.S. adopts tough new regulations for OTC derivatives, the market will move overseas. Unaccountably, the discussion draft actively encourages dealers to seek out the weakest regulatory regime. It does so by providing an exemption from U.S. regulation to any standardized foreign transaction regulated by foreign regulators. If such an exemption foreign transactions is necessary, it should apply only where U.S. regulators find that the foreign regulatory regime is as comprehensive and rigorous as our own.

- **Hold dealers accountable when they violate the law.** Under the provisions of the discussion draft, an unregulated derivative contract must be enforced even if it defies all of the bill's requirements to escape regulation and otherwise is unconscionable. This is an invitation to abusive practices that must be eliminated from the legislation.

The history of derivatives regulation is one in which, time and again, the dealers have succeeded in convincing policymakers that regulation would stifle innovation, inhibit the ability of companies to hedge their risks, or drive the market overseas. In response to these well rehearsed and self-serving arguments, derivatives regulation has gotten successively weaker over the years even as the unregulated market ballooned in size, first with the rules adopted by former CFTC Chairman Wendy Gramm and then with the passage of the Commodity Futures Modernization Act. The American people are paying a very heavy price for that lax regulation, which allowed unregulated OTC derivatives products to threaten to bring down the global financial system.

Unfortunately, even after everything we as a nation have been through, the discussion draft follows that same trend. As described above, it opens up broad new loopholes that, if retained, will allow not only customized derivatives but many standardized derivatives to escape regulation and will actively encourage a migration of the market to the least regulated venue. Unless these loopholes are closed, the financial system will remain exposed to excessive risks, dealers will continue to charge excessive spreads, end users will continue to use the opaque derivatives markets to engage in conduct indirectly that they would not be permitted to engage in directly, and Congress will have missed an important opportunity to address significant threats to the financial system and to the economy as a whole.

Respectfully submitted,

Barbara Roper
Director of Investor Protection

cc: Members of the Committee on Financial Services