DERIVATIVES STUDY CENTER

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MEMORANDUM

To: Senate Agriculture Committee, Round Table

From: Randall Dodd

Re: Proper regulation of energy and metal derivatives

This brief memo contains my views on the latest version of the legislation known as S. 2724 or the "Feinstein Amendment." First let me commend the bill's authors strongly for a timely and earnest effort to provide a remedy for markets that are not working properly. The bill makes a substantial improvement to the regulatory framework that will enhance the efficiency, stability and growth of these markets. I offer many praises for the bill's achievements, and only a few suggestions on needed improvements.

The bill will accomplish the very important task of introducing registration and reporting requirements to the markets in over-the-counter (OTC) energy and metal derivatives. The U.S. economy uses about $600 billion of energy and $177 billion of metal annually, and so it is imperative that the related derivatives markets function in a safe, sound and efficient manner and trade at prices whose integrity is assured.

The bill requires bilateral dealers to "provide notice" and authorizes the CFTC to write rules defining this obligation. In doing so, the CFTC should specifically require that dealers are well managed and that their traders be competent and free of criminal records for fraud and other trading violations.

The bill also deserves praise for establishing much needed reporting requirements and it specifically calls for large trader position reports. This is a critical tool for the CFTC's ability to detect and deter manipulation, and it would greatly weaken market integrity if this provision were removed. The legislation also makes a major stride in improving market transparency through the provision requiring the timely release of market information such as trading volume and open interest.

In regarding the reporting requirements, the CFTC is well suited to write rules designating what information should be made public, and in what manner, and what information is proprietary and should be retained for surveillance and enforcement activities. Investors will know that the material is being provided to the public authorities for market oversight, and this should bolster confidence in the integrity of the marketplace.

As good as it is, the bill can become better. The section defining capital requirements can be improved with some small, clarifying changes. In general, the language in this section could be improved so that it is more easily understood to mean that the requirement in Section (B) applies to bilateral dealer markets in which there is an electronic multilateral brokering platform <u>or</u> binding bid and offer quotes. Section (A) requires the adoption of a VAR model, but the requirement to hold capital in proportion to the value at risk appears to be omitted. In Section (B), the requirement is said to apply to a bilateral dealer "market." A market may be comprised of many entities including an electronic brokering platform, dealers, end-users, firms doing proprietary speculation and possibly more. The firm providing the platform does not generally hold any risk because they participate in the negotiating process but not the actual derivative contract. All other participants hold risk, and the bill should establish the important requirement for the dealers to hold capital commensurate with their activities. If the market is organized so as to clear trades through a clearing house, then the concentration of the market's credit risk into the clearing house makes it imperative that the clearing house maintain adequate capital and other measures to successfully manage its risk.

One important issue that is not addressed in the bill is collateral requirements. Exchange traded futures and options, as well as stocks traded on the NYSE and NASDAQ, are transacted with margin or collateral requirements. OTC energy and metal derivatives involve at least as much risk as these other transactions and yet they are not covered by any minimum collateral requirements. Collateral problems were critical in the failure of Long Term Capital Management and one reason that Enron failed in the way it did. This bill would be strengthened if it included measures designed to establish the prudential use of collateral in OTC energy and metal derivatives markets.

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