

United States Senate

WASHINGTON, DC 20510

February 12, 2010

The Honorable Blanche Lincoln
Chairman
Committee on Agriculture, Nutrition, and Forestry
United States Senate
Washington, D.C. 20510

Dear Chairman Lincoln:

We are writing to express our strong opposition to exemptions from over the counter (OTC) derivative market regulatory reforms. As you know, in 2000 Congress made the mistake of exempting energy from commodities regulation in the Commodity Futures Modernization Act. This exemption, known as the "Enron Loophole," led directly to the Western Energy Crisis. We strongly believe that arguments for an exemption are rooted in the deregulatory ideology that has brought our economy to its knees, and we recommend that you seriously question the assumptions underlying the industry's position.

We are deeply concerned that derivatives traders fail to acknowledge the dangerous systemic risk their products inherently create for our economy, even after our financial system was devastated by these products in 2008. Wall Street banks advocate continued off exchange, uncleared, highly leveraged derivatives trading because they find it extremely profitable to shift risk to a Federal government unwilling to let them collapse when their bets go bad. Likewise, some "end users," and in particular energy companies, advocate uncleared derivatives, even though they know that their own balance sheets would have been at serious risk had the Federal government not stepped in to shore up the swaps dealing Wall Street banks with whom they traded in 2008. If the Federal government fails to impose systemic risk controls on derivatives traders, these traders will continue to shift substantial systemic risk onto Federal taxpayers, and we may experience further financial market failure in the near future.

Specifically, energy traders and other derivative "end users" argue that exchange trading and clearing derivative transactions would impose an undue cost on firms that want to hedge risk. They have requested an exemption from all clearing requirements. We believe such an exemption would be a mistake, for the following reasons.

- Transactions between swaps dealers (Wall Street banks) and "end users" constitute a significant percentage of all over-the-counter transactions. As long as these

transactions are not cleared, Wall Street banks will continue to maintain massive derivative positions outside the clearing system. The collapse or default of any major swaps dealing Wall Street bank would create a systemic failure in the energy markets, similar to the systemic failure caused by the bankruptcy of Enron in 2001 or the collapse created by uncleared credit default swaps held by Lehman Brothers and AIG in 2008.

If, on the other hand, Congress mandates derivatives clearing, a recent example demonstrates that we could avoid systemic failure. After the failure of Enron, the natural gas industry began submitting energy trades for clearing. As a result, no systemic failure resulted when the largest natural gas trader, Amaranth, unexpectedly went bankrupt in 2007.

- There is no free lunch. “End users” currently pay significant fees to swaps dealing Wall Street banks, but not margin payments. These fees serve as the major profit center in the derivative business. If the “end users” had to clear their contracts, they would face margins instead of fees. However, because trades, fees and derivative products would be transparent, competition would likely reduce the costs to end users.
- Insuring against systemic failure has a cost, as does any insurance program. Some traders prefer OTC transactions in the short term because they do not have to pay the cost of preventing a market collapse, but this is the equivalent of ignoring the risk of fire and arguing that homeowners’ insurance is a waste of money. An effective systemic risk regulator will either require transactions be cleared or require significantly higher collateral postings on derivative transactions in order to reduce the systemic risk to swaps dealing Wall Street banks posed by their massive uncleared OTC derivative positions.
- Uncleared OTC transactions depend entirely on a mutual assessment of credit-worthiness by the “end user” and the swaps dealing Wall Street bank. Allowing the stability of our energy markets to depend on these assessments would ignore a key lesson of our current financial crisis.

In the 2008 crisis, sophisticated financial institutions failed to manage their own risk exposure, as advocates of financial market deregulation had forecast. The “self-interest of lending institutions to protect shareholder’s equity” did not prevent excessive risk taking. Bankers gambled stockholder value, creating systemically dangerous levels of risk in the pursuit of short term profits. Likewise, “end user” derivative buyers assumed that the Wall Street banks selling OTC products were credit worthy, and had no viable recourse when the banks failed. Municipalities and other creditors were devastated by the bankruptcy of Lehman Brothers, and their exposure to other large financial institutions led the Federal government to bail out other banks.

- Recent history clearly demonstrates that not all traders accurately assess the risk posed by their counterparties, and all Federal regulatory agencies have advocated clearing derivatives in recognition of that fact. For instance, Walter Lukken, who was *Acting Chairman of the Commodity Futures Trading Commission during the 2008 crisis*, wrote in *The Wall Street Journal* in December 2008: “centralized clearing is one immediate step that can tangibly reduce risk in the markets and benefit the U.S. economy.” Unfortunately, this unnecessary and unacceptable risk continues to this day in our financial markets. Considering this history, Congress cannot justifiably allow any systemically important financial institution regulated or insured by the Federal Reserve, the Federal Deposit Insurance Corporation, or a newly created systemic risk regulator to execute uncleared OTC derivative transactions, even with “end users.”
- Companies, municipalities, and commodity “end users” with strong credit ratings argue that swaps dealing banks require them to post lower margins in recognition of their low risk of default. The stability of the system therefore depends almost entirely on the credit rating agencies, which should raise serious questions considering the agencies’ failure to assess the risk of credit default swaps, mortgage backed securities, or major financial institutions accurately. However, if traders continue to put faith in the rating agencies, the same low cost option could be accomplished by establishing exchange traded and cleared products for sale exclusively to highly rated firms.

We strongly oppose efforts to perpetuate over the counter trading practices that pose systemic risk, but we believe legislation to establish a regulatory framework should recognize the unique needs of “end users.” Congress should take the following steps to ensure that utilities, airlines and other energy end users are able to hedge against energy price volatility.

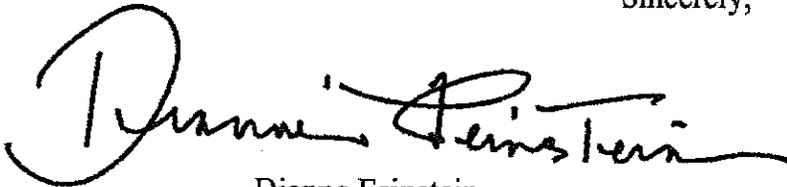
- All derivatives should be subject to transparency, exchange trading, and clearing requirements, unless the Commodity Futures Trading Commission (CFTC) has made a particularized determination to grant a specific exception from regulation for that product based on a public interest or necessity finding. The burden of proof should lie on the developer of new derivative products to prove the need or benefit of the exemption, not on the regulators to prove the need and benefit of clearing or oversight. CFTC should be required to report to Congress not less than once a year detailing any such exceptions.
- Companies, municipalities, and commodity “end users” that are asset rich, but cash poor, should have access to a mechanism to use non-cash collateral to meet margin calls, instead of requiring these firms to post exclusively their own cash. Large financial institutions could be required to provide this service at low cost to entities

such as regulated utilities with low risk business models, or the Federal government could provide this service.

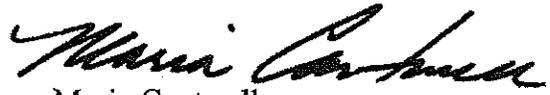
- To the extent that regulators are comfortable with the accuracy of credit rating agency work, clearinghouses should be encouraged to offer some contracts exclusively to entities with exceptional credit ratings.

We look forward to working with you to assure that Congress passes strong legislation to restore the public's faith in financial and commodity market stability and sound oversight. We hope you share our belief that we have to be especially aggressive in our oversight of the over the counter markets. If you have any questions, please do not hesitate to discuss these matters with us.

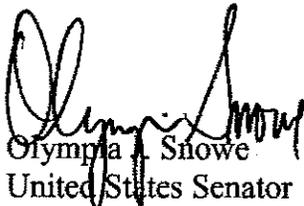
Sincerely,



Dianne Feinstein
United States Senator



Maria Cantwell
United States Senator



Olympia Snowe
United States Senator



Byron Dorgan
United States Senator

CC: Chairman Dodd
Ranking Member Chambliss
Ranking Member Shelby